Foreign fiscal policies appear to be moving toward stimulus very slowly. The actions taken in Japan to stimulate domestic demand have generally been viewed as of modest magnitude. Continued record unemployment in Europe has yet to result in strongly expansionary fiscal policies. The possible enactment of the Gramm-Rudman-Hollings Bill would increase the need for more expansionary policies outside the United States. That bill, if followed to the letter, would compel declining U.S. budget deficits.

Foreign considerations also complicate an assessment of U.S. monetary policy. For the Federal Reserve to offset the negative impact of a rising foreign-trade deficit on U.S. growth, it must allow interest rates to fall sufficiently to create a compensating acceleration of domestic demand. However, myriad new uncertainties over the magnitude of the trade deficit's further deterioration, prospects for the dollar, and the dollar's effect on future inflation and foreign trade are added to the usual questions of how the domestic sectors will respond to declining interest rates. The slowdown in the economy since mid-1984 and the failure of real growth to accelerate to the 4-percent area the Fed predicted for the second half of this year suggest that the monetary authorities did not allow interest rates to fall rapidly enough during the past 15 months to compensate fully for the foreign-trade drag. Although some of the most recent changes in indicators of Fed policy raise questions, monetary policy, on balance, appears quite expansive.

The Outlook by Sectors

A more complete assessment of the outlook should also include an evaluation of conditions in the major sectors of the economy, searching for evidence of imbalances, which could trip economic growth, and for signs of the degree of policy stimulus to private spending decisions. The low personal saving rate and rapid expansion of consumer debt top most current lists of potential imbalances. Our latest analysis, however, confirms our earlier conclusion on this issue—U.S. consumers are not seriously overburdened with debt. Consumer debt outstanding and debt service for the average family are well below previous peaks after several factors are considered—the relatively rapid growth of the heavy-debt-using 25 to 44 age group, lengthening of loan maturities, tax deductibility of interest payments, convenience credit-card use. Although the personal saving rate should move back up to the 3-percent area (from less than 2 percent in September) as auto sales return to a more normal pace, downward pressure on saving is likely to continue as long as the Federal Reserve seeks to offset the foreign drag on U.S. economic growth with lower U.S. interest rates.

Business fixed investment fell almost 5 percent (annual rate) last quarter in real terms: the first significant decline since 1982. A rebound is likely this quarter, based on the strong capital equipment orders and shipments and nonresidential construction contracts of recent months. These quarterly swings are likely to average out to only modest net increases in real capital spending until overall U.S. economic growth has accelerated. The near-term increases in business investment appear capped by lower capacity-utilization rates, while their downside is limited by relatively high business cash flows.

Inventory accumulation should not add significantly to growth until some time in the first half of next year. While inventory liquidation occurred last quarter for the first time since 1983, its composition does not suggest an imminent reversal and boost to the economy. All of last quarter's liquidation was in automobiles, reflecting the stimulus to sales from the temporary, promotional loan rates. Nonauto inventories continued to increase.

The stimulus to growth from the declining dollar is also unlikely to occur before the first half of next year. The negative effect on growth from rising imports is likely to continue to be severe through the second half of 1985, but the first signs of its eventual diminution have recently appeared in reports of price increases on imported goods due to the falling dollar. Therefore, despite the stirring in some of the latest economic statistics, the near-term outlook is for only modest acceleration above the slow growth of the first half. We continue to project a 2 to 3 percent range for economic growth in the second half of this year—with a possible downward revision of the government's 3.3 percent preliminary real GNP growth for last quarter. This second-half estimate remains weaker than the latest consensus of forecasts.

We continue to believe that a significant acceleration of growth will begin in the first half. The primary cause will be a reduced drag on the economy from the trade deficit. Its effect on the manufacturing sector should be amplified by an upturn in the inventory cycle and spread through the rest of the economy by the pickup in income growth. Our estimate of real GNP growth between the end of 1985 and the end of 1986 is still in the 4 to 5 percent range, above the consensus forecast.

A Long-Wave Hypothesis for the United States

Albert T. Sommers

In its original form, posing mechanistic periodicity and inevitability as characteristics of a long wave, the 50-year "Kondratieff" cycle makes very little sense logically. But this should not rule out consideration of a real, causal, logical long-wave component in economic history. The search for such a wave should begin with the identification of a set of highly abnormal, extreme conditions carrying a powerful net balance of stimulus and going far beyond anything that would be contemplated by discretionary economic policy in ordinary times. The long-wave thesis should thus identify the energy created in the initial abnormal state, and seek to measure its rate of exhaustion.

Conditions prevailing almost exactly forty years ago at the end of World War II qualify spectacularly as a time of gross discordance in world economic conditions, containing a huge volume of static economic energy—an unprecedented voltage accumulated over ten years of worldwide depression followed by five years of very nearly total war. Private debt and the capital stock had shriveled, whereas unexploited technology and liquidity had increased enormously. To these necessary and sufficient conditions for a "big bang"—and the onset of a long wave—should be added the fact that the United States emerged from World War II in a condition of economic and technological dominance unsurpassed in the history of any nation anywhere.

In short, there has never been a better candidate for the necessary accumulation of violent energy than the fifteen years ending with peace in 1945. The end of World War II marked a spectacular new dawn for the U.S. economy.

This is a solid case for an explosion capable of generating a long wave. But the empirical study of its course through time should not be expected to reveal a high degree of regularity or periodicity, or a clear continuity of evidence. What we should seek, instead, is evidence of progressive exhaustion of the strengths out of which the wave originated. And what we find is that a coherent, comprehensible course of declining energy is visible in all of the fundamental components of the wave. In fact, the exhaustion in so many (not necessarily all) of these areas is so far advanced as to suggest that the United States is already on the leeward side of the wave, and is now struggling against a withdrawing underlying tide.

The private debt burden would now appear to be mature, by almost any criterion. Ratios of debt to the income flows that must service them are high (and still rising) throughout the private sector. Defaults and bankruptcies are rising. Federal debt is growing rapidly—faster than the growth of aggregate debt, so that the share of federal debt in the total is rising, as it characteristically does during periods of weak business conditions. Further, the end of inflation is making the debt burden more onerous.

The current condition of economic policy carries the same suggestion of exhaustion. In 1985, a huge budget deficit has been accompanied by accommodative monetary policy—the policy posture normally adopted in periods of serious recession. The system's sluggish and uncertain growth in response to this massive stimulus is further testimony to the withdrawing underlying tide in the system.

Albert T. Sommers

The economy is struggling against a withdrawing tide.

Finally, the international position of the United States, which was one of its most extraordinary strengths at the start of the long wave, has reversed with a vengeance. The U.S. trade position has deteriorated with respect to virtually all of its markets. Its technology is available around the world, where it is generally associated with labor costs that are a fraction of the labor-cost level built into the United States system through thirty years of an ascendant long wave.

These changes—in debt position, in liquidity, in inflation, in the response to policy stimulus, in international trade and income flows—can be viewed as deteriorations in individual areas. But their interconnections are substantial. Together, as they would be viewed in a long-wave hypothesis, they describe progressive involution of virtually all of the conditions on which the birth of the long wave rested. Their deterioration has reached a point that suggests that the cumulation of the wave, and its reversal, are now at least a few years in the past, and that the system is now already well into a struggle to offset a cumulative drain on its energies.

Policy Implications

The proper conduct of policy for now and in the future should take conscious and deliberate account of the vulnerabilities suggested by the long-wave hypothesis. The hypothesis carries the suggestion of large dangers, requiring substantial defensive treatment. The prescriptions that it suggests are different from the standard prescriptions that would be arrived at apart from the hypothesis. The hypothesis calls for a careful, progressive, even slow and measured effort at reduction of the U.S. federal deficit. What is ignored in arguments for determined and rapid reduction in the deficit is the

fact that a deficit reduction is inherently deflationary; the hypothesis suggests that this is no time to undertake radical deflationary surgery on the budget.

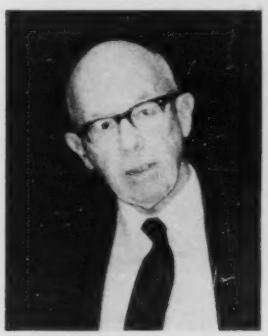
Likewise the thesis warns urgently against restrictive monetary policy—here or in any other major country. At the end of the great wave, the world gives the impression of requiring reflation if the pyramid of debt is not to deteriorate at a cumulative rate. The thesis argues, further, against general protectionism and, beyond that, for effective international cooperation in the coordination of economic policies, in trade, in the financing of international lending organizations, in the stabilization of currency-exchange markets. Far more than ever before, the world is joined in its trade, currency and financial markets; going it alone carries major risks for all.

In conclusion, the documentation for the long wave, and the proposition that its present condition represents a time of troubles, is incomplete, but respectable. It is not strong enough to offer unequivocal prescription; but it is certainly strong enough to require serious consideration. By its nature, a long-wave hypothesis is conjectural, and inferential. A determination of its present position is bound to be partly an act of intuition and insight. The thesis advanced here—that a long wave was born forty years ago in an explosion of fifteen years of accumulated energies, and that those energies have been largely consumed—is a usable thesis, carrying an impressive body of implications for private business and for public policy. To ignore it is to set aside a powerful conceptual structure for ordering the history of recent years, and placing the seemingly paradoxical conditions of the present into a revealing perspective.

Prices, Costs, Productivity and Profits

Geoffrey H. Moore

Since the 1984-85 growth recession appears to be losing its grip on the economy and expansion seems likely to continue for a while, it is worth considering what previous long-lived expansions have to tell us about prospects for inflation. Between 1949 and 1980, there were three business-cycle expansions that lasted more than 40 months: in 1949-1953, 1961-1969, and 1975-1980. Since the current expansion has already lasted 36 months, the three long-lived expansions are—hopefully—relevant to the current outlook. We have, therefore, constructed recovery patterns that compare the current expansion to date with the average of the three longer expansions during their first 48 months.



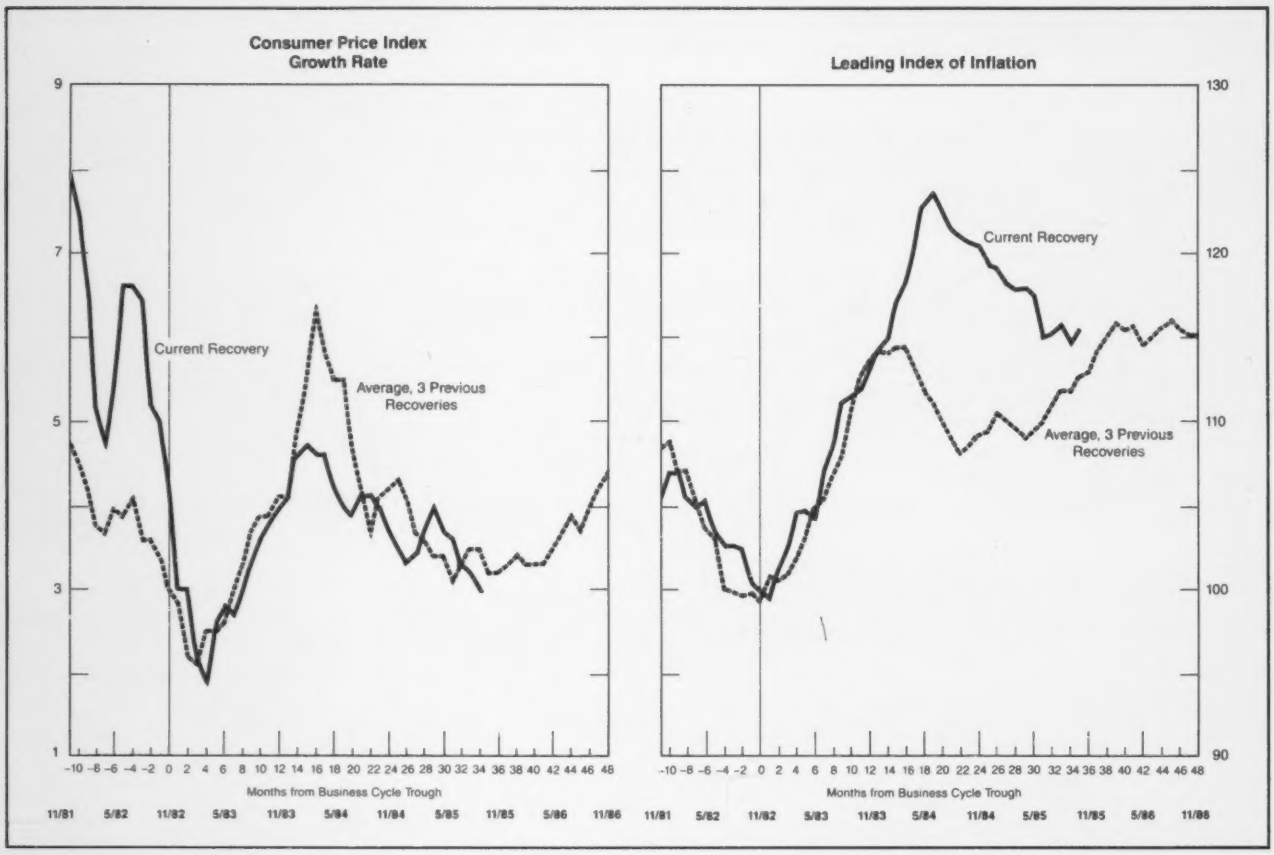
Geoffrey H. Moore

A modest acceleration of inflation.

Recent price inflation has been tracking the previous average pattern very closely (see chart, page 11). The rate for the consumer price index, measured by a method that smoothes away most of the erratic movements, was 3.0 percent in September, which compares to an average rate of 3.5 percent at this point in the three long expansions. In the average pattern there was a little upward drift in the fourth year, and a corresponding rise now would bring the rate up to about 4 percent by the end of 1986.

The leading index of inflation, which has had both a large upswing and a smaller downswing in this recovery (which led the inflation rate nowhere) now seems to be getting back in line both with its average pattern and with the inflation rate. Its errant behavior against inflation was due to some unusual shifts in the relations between its three components and subsequent inflation. The rapid rise in the percentage employed to an all-time high early this year did not have its usual consequence: Wage inflation remained quiescent. The rapid rise and fall of industrial materials prices did not have its usual consequence: Commodity-price inflation at the finished goods level scarcely budged. The enormous rise in total debt, which has subsided but by no means disappeared, did not have its usual consequence: The general price level advanced sedately.

Why did inflation remain so subdued this time around? Much of it probably can be blamed on the rise in the dollar exchange rate, which kept import prices down and worsened the competitive position of our basic industries, including farming. Deregulation was another factor intensifying competition and reducing prices. The weakening of OPEC produced a sort of reverse oil shock, reducing energy prices. Labor unions have lost strength, both absolutely and relatively, partly because of the growth of the service industries. Widespread indexing of wages, social-security payments, and other contracts means that a declining rate of inflation now has more feedback effect. The reversal of inflationary expectations, built up during the 1970's, also has feedback effects on wage demands, interest rates and the cost of financing, inventory accumulation, and advance buying.


Consumer Price Index
Growth Rate
Current Recovery
Average, 3 Previous
Recoveries
Months from Business Cycle Trough
11/81 5/82 11/82 5/83 11/83 5/84 11/84 5/85 11/85 5/86 11/86
Leading Index of Inflation
Current Recovery
Average, 3 Previous
Recoveries
Months from Business Cycle Trough
11/81 5/82 11/82 5/83 11/83 5/84 11/84 5/85 11/85 5/86 11/86

A Modest Speed-Up

There is no lack of unusual developments to point to, but the fact remains that the leading inflation index and each of its components is now higher than when the recovery began. My view is that, because of the factors cited, its lead time against inflation has lengthened, but that the underlying relationship remains. A modest rise in the inflation rate during 1986 to 4 or 5 percent would be consistent with that view.

This prospect is supported by the upward drift in unit labor costs, which increased in the third quarter at a 3.5 percent rate, exactly the same as in selling prices. The average gain in costs during the three previous expansions at this stage was also 3.5 percent, and that average shows an upward drift to about 4 percent during the fourth year.

I would expect productivity to pick up a bit more as we leave the effects of the growth recession behind. The third-quarter rate was only 0.5 percent, as we calculate it. That could easily get back to the 2-percent level later this year and in 1986, which would put it in line with the average pattern of previous four-year-old recoveries.

Rates of gain in hourly compensation, which include both earnings and fringe benefits, have been in the neighborhood of 4 percent for the past two years. This is an unusually subdued rate, even relative to the reduced rate of gain in prices. Hence, real wages have shown virtually no gain—in contrast to previous experience when the average gain during past recoveries has been about 2 percent. However, there has been a slight upward drift in the rate of gain of real wages since the fourth quarter of 1983, and I would not be surprised to see this continue in 1986, especially if productivity grows faster.

Getting to the bottom line, profitability, we need to compare the rates of gain in prices with those in costs. Labor costs are not total costs, but they do comprise a large and dynamic share of the total. During the early stages of most recoveries, including this one, selling prices rise more rapidly than unit labor costs. Indeed, the differential in favor of prices increases for a year or so, which means that profit margins recover rapidly from the depressed level to which they fell during the recession. Then costs begin to catch up with prices; the improvement in margins slows and finally stops. That is precisely what happened in 1983, 1984, and 1985.

According to the Commerce Department's ratio of corporate profits after taxes to corporate domestic income, profit margins have made a dramatic recovery since 1982, and are now back to 10 percent, their average level in preceding recoveries. This measure pertains to profits after inventory valuation and capital consumption adjustments. It excludes inventory profits or losses by valuing inventories at replacement costs, and it excludes the effect of accelerated depreciation as permitted by the tax code. These adjustments have

made an enormous difference in the level of profits in recent years. In the second quarter, the margin would have been 6 percent without the adjustments, instead of 10 percent. Moreover, the improvement during this recovery would have been much smaller without the adjustment, since both figures were close to 5 percent when the recovery began. In general, I believe the adjusted profit figures are more realistic as well as more consistent with the price/cost relationships we have been discussing.

What happens next year depends on whether prices continue to keep pace with costs or whether they go further ahead or fall behind. I would say that both are likely to accelerate moderately next year into the 4- to 5-percent range. But the matter should be closely watched: It is an early sign of recession when costs begin to climb significantly faster than prices. At the moment, the race is neck and neck.

To sum up, looking ahead into 1986 I see: (1) a modest advance in the inflation rate into the 4- to 5-percent range, matched by a similar rise in unit labor costs; (2) a faster rise in wages, up to the 6 percent area; (3) recovery in productivity growth, to around 2 percent; and (4) profit margins holding at their recent levels.

Prospects for Tax Reform and Deficit Reduction

J. Gregory Ballentine

Dramatic revenue-neutral tax reform appears likely to evolve into more modest revenue-raising reform, and that is probably a good development. Not only are more tax revenues needed, but the trend in revenue-neutral tax-reform proposals is toward a sharp increase in the overall tax rate on business capital income. The damage done by such a shift in the tax burden may outweigh the advantages reform can bring in achieving a more equal tax rate among alternative business investments.

Revenue-neutral reform of the *personal* income tax can only achieve a sharp decline in personal income-tax rates by eliminating, or sharply curtailing, some itemized deductions. Doing so, however, raises an inescapable dilemma: Only about 60 to 65 percent of middle-income taxpayers itemize. If personal tax rates are lowered and the revenue loss is offset by a reduction in allowable itemized deductions, then most middle-income itemizers must pay more taxes, while middle-income non-itemizers will pay less. This, in turn, would mean that virtually every homeowner earning between $20,000 and $40,000 would pay more taxes. Obviously, the political system will not allow that. As a result, before any politically attractive revenue-losing provisions are even considered, the basic structure of current reform proposals dictates an overall reduction in personal income taxes and a sharp increase in corporate taxes.

The reform proposal before the House Ways and Means Committee embraces and enlarges this shift to higher corporate taxes. Further, the trend in the Committee seems likely to expand the shift even more. If such reform actually passes, we can expect a dramatic increase in the tax burden on business capital income with a corresponding decline in the tax burden on labor income. (Wages and salaries comprise about 85 percent of all "adjusted gross income.")

While this shift may reduce net saving in the United States, proponents of the recent reform proposals point out that reform will result in a more efficient use of U.S. saving by equalizing tax rates across business investments. It is certainly true that the reform proposals may generate efficiency gains by improving the allocation of investment among businesses, but they may also generate efficiency losses by worsening the allocation of savings between business and nonbusiness investment. The wide differences in effective tax rates across business investments has attracted considerable attention and is a legitimate issue for reform. Unfortunately, proponents of reform have seemingly ignored the equally important problem of differences in tax rates between business and nonbusiness investments.

J. Gregory Ballentine

Substituting a political crisis for an economic crisis.

More than 40 percent of the depreciable U.S. capital stock is completely exempt from income taxes, at both the personal and corporate level. That capital is not business capital; it is consumer durables, including owner-occupied housing. Political reality dictates the continued tax exemption of such capital. As a result, tax reform that seeks to reduce disparities in tax rates across investments should seek to lower the tax rate on business capital as a whole (while equalizing tax rates among different business investments) in order to reduce the

huge tax penalty on business savings compared to nonbusiness savings. Recent proposals do not do this. Indeed, they tend to return our tax system to the situation of the late 1970's when the disparity between the tax treatment of consumer durables and that of business investment widened, tending to expand nonbusiness investment at the expense of productivity-enhancing business investments.

If a tax-reform bill passes that raises the tax rate on business capital income, the damage being done by the deficit will be aggravated. During the period 1980-1985, total U.S. saving (net of the deficit and net of depreciation) has been less than 4 percent of net national product. In contrast, during the 1950's, the savings rate was about 7.7 percent; it was 8.0 percent in the 1960's, and 7.0 percent in the 1970's. The major reason for this decline is the increased federal deficit. Now is possibly the worst time to redistribute the burden of taxation so as to fall more heavily on business savings, while leaving total revenues unchanged.

Efforts to Reduce the Deficit

It appears that dramatic tax reform will not be enacted, however. Instead, the passage of some version of the Gramm-Rudman-Hollings deficit-reduction proposal will likely lead to a 1986 tax increase (which will, of course, be labeled as tax reform). While that tax increase will probably fall heavily on business investment, nonetheless, if it lowers the deficit, its net effect will be to encourage net business saving.

The Gramm-Rudman-Hollings proposal sets targets for the deficit for 1987 through 1991 that begin at $144 billion in fiscal 1987 and decline by $36 billion a year to zero in 1991. Unlike previous statements of congressional intent to balance the budget, this proposal has an enforcement mechanism: If the targets are not met, the President is directed to make uniform cuts in a subset of government programs that excludes social security, many defense contracts, and certain other programs.

The key point about Gramm-Rudman-Hollings is that the results of the enforcement mechanism are likely to be so unpalatable to both the White House and Congress that they will be forced to achieve some compromise deficit-cutting package next year. My rough calculations suggest that, even assuming the Administration repeats all of its fiscal 1986 proposals that have not been enacted, it will still face deficits well above the GRH target for fiscal 1987, and even more above the targets for later years. Congress will almost certainly be unwilling to enact those Administration proposals, much less the deeper cuts the Administration may propose to meet the targets. As a result, the specter of the enforcement mechanism will have to be faced.

The White House will likely find the across-the-board cuts stipulated by the enforcement mechanism to be unacceptable because deep cuts in certain segments of military spending will be required. Congress will find across-the-board cuts unacceptable for many reasons, including the fact that many domestic programs that have most of their spending based on prior year policies (e.g., guaranteed student loans and some HUD programs) will have new activity dramatically curtailed by even modest outlay reductions.

Many persons have speculated that the deficit will not be dealt with finally until Congress perceives the deficit as causing an economic crisis. The Gramm-Rudman-Hollings proposal should be viewed as substituting a political crisis for an economic crisis. It may well force everyone to the bargaining table to negotiate plans similar to those agreed to in 1982 and 1984. Those plans took significant action against the deficit through a combination of tax increases, domestic-spending reductions, and defense-spending restraint. Even if the resulting tax increases fall on business investment, the net effect of such a deficit-reduction package can be a significant increase in net U.S. saving. Thus, replacing current tax-reform proposals with such a package may be a step in the right direction for the capital markets.

Profound Turnaround on the Dollar

Roger M. Kubarych

In September, acting in collaboration with the finance ministries of Japan, Germany, Britain and France, the Reagan Administration announced a major change in international policy toward the dollar. What the Administration said, in effect, was that the international currency markets had gotten it wrong. The dollar had climbed too high, and had stayed too high too long. Accordingly, a blend of economic policy changes, buttressed by massive central bank intervention in the foreign-exchange markets, was needed to get it right.

For Washington, this agreement marks a profound turnaround in philosophy and approach. Ultimately it will have far-reaching consequences for trade, economic growth, and inflation. The magnitude of the policy shift cannot be minimized. Until September, this Administration had been the resting place for three very different views of the dollar, all of which led to the same policy recommendation—leave the dollar alone.

- View Number 1 was that a strong dollar is basically a good thing, regardless of the short-term damage it does to our industrial competitiveness and our trade deficit. It keeps inflation low. Also, it puts pressure on allegedly slow-moving corporations to become more efficient, to drop lines of business in which comparative advantage had clearly moved offshore, and to manage labor relations better. Perhaps more important, the high value of the dollar is seen as signifying a vote of confidence by foreign investors in the overall thrust not only of U.S. economic policy in the broadest sense, but also of U.S. initiatives in the political and national security areas. As one Japanese banker said, it was the era of the "Star Wars Dollar." The implication of this view: Enjoy the benefits of a strong dollar, do nothing to compromise them, but acquiesce to selected pleas for help by industries most seriously affected (cars, steel, and a few others).
- View Number 2 had a different flavor. It derived from the belief that exchange markets are efficient, and thus it is meaningless to think of the dollar as being overvalued or undervalued: It is wherever the market puts it. Intervention, whether by central banks buying or selling currencies, or by governments imposing restrictions on international capital movements, would be ineffective, at the least, and probably harmful. The implication of this view: Be indifferent to the dollar's movements; do nothing about them: but *don't* offer special help to troubled industries either, because that also distorts the markets.
- View Number 3 reflected an entirely different brand of economic thought—more analytical, less ideological. It held that the culprit is the U.S. budget deficit, which represents a massive drain on the nation's limited home-grown savings. The budget deficit causes high real interest rates, which pull in funds from abroad and make the dollar high. The high dollar, in turn, stimulates imports and discourages exports, which leaves the trade balance in deficit. But that trade deficit is the very source of foreign savings needed to fill the savings gap left by the budget deficit. On this reasoning, the U.S. needs to fix the budget deficit. In the absence of that, the dollar will have to remain strong enough to close the loop. The implication of this view: Do nothing about the dollar directly because it will divert attention away from the real need (to cut the budget deficit) and won't work anyway.

Roger M. Kubarych

The new policy on the dollar is only the beginning of the treatment.

Within the Administration these three views have now been shunted to the side, as growing protectionist pressures—virulent enough, perhaps, to plunge the world into a vicious cycle of new trade restrictions—posed an immediate threat. Thus, doing nothing about the dollar has become more dangerous than acting to deal with the overvaluation.

Coming Full Circle

Accordingly, the Administration has come full circle to the policy view that prevailed before it took office: Markets can and do overshoot seriously. When they do, intervention can be a useful tool to get market psychology back to earth. To be sure, fundamental policy shifts are indispensable. Sooner rather than later, the United States must cut the budget deficit; Europe must expand faster; Japan must import more; the LDC's must be financed so they can again grow at tolerable rates. But until all that transpired, to do nothing about the U.S. trade deficit, which is the same as doing nothing about the dollar, was no longer a viable strategy.

How soon will the results come, and how great will they be? They will come slowly and not dramatically and they will possibly be very disappointing to protectionists, who now are taking a wait-and-see attitude. It is a near certainty, therefore, that the trade issue is not behind us. Only the beginning of the treatment has been prescribed, not the whole cure.

Household Spending and the Expansion

Allen Sinai

In 1986, as has been the case for much of the past few years, consumer spending will be one of the keys to whether the current expansion can be sustained. Since the fourth quarter of 1982, household spending has been a driving force in U.S. economic growth. Sharp rises in disposable income, fueled by the Kemp-Roth tax cuts of October, 1981, July, 1982, and July, 1983; unsatisfied pent-up demand for big-ticket items, particularly houses and automobiles; declining rates of inflation; falling nominal interest rates; rising household net worth; a generally confident consumer; and an easy availability of finance all have provided the underpinnings for the consumer-spending boom.

During the first three quarters of 1985, the consumer carried the economy upward, with real outlays rising at a 5-percent annual rate, compared with 2 percent for the overall economy. Can the consumer keep it up? Likely not, with the odds favoring a substantial slowdown, but no collapse, in consumer spending during the fourth quarter of 1985 and in 1986.

Current prospects suggest a negative turn in consumer spending during the fourth quarter, a drop of 1 to 1½ percent, as households retrench from the spending and borrowing boom of earlier months. In particular, expenditures on durable goods are expected to decline nearly 20 percent, at an annual rate, reflecting a huge decline in automobile sales—from 12.4 million units in the third quarter to 9.2 million units in the fourth quarter. Other categories of consumer outlays should rise only slowly, as households attempt to save more out of modest increases in income.

For 1986, the range of growth expected for consumption spending is 2 to 2½ percent, with considerable weakness in spending for durables and nondurables, but less of a slowing for services. Sluggish growth in real disposable income, a need to work debt-to-income ratios lower, still high debt service, and caution in buying as saving is increased are major reasons for the reduced pace of spending.

Allen Sinai

The consumer: Slowing but no collapse.

Automobile sales will be one of the casualties of the retrenchment, averaging 10.5 million units in 1986 compared with 10.8 million in 1985. Nearly 30 percent of auto sales can be expected to be in imports. Retail sales are also likely to grow more slowly, rising 6.3 percent in nominal terms. Households will remain cost and bargain conscious, given that past spending and borrowing behavior has resulted in an overextended financial position. A weaker consumer picture can be expected for the following reasons:

- Households must begin to retrench at this point because the heavy spending of previous quarters has outstripped growth in real disposable income, has brought sharply higher indebtedness relative to income, is engendering high and rising debt service, and has resulted in an extraordinarily low rate of personal savings. Clearly, consumers cannot keep up the previous pace of spending and borrowing. The issues are when and how much of a decline is in prospect.
- The financial position of households has deteriorated considerably. Debt ratios—for consumer or mortgage credit, or both—are at a post-World War II high as a percent of disposable income—78 percent for total debt/income during the third quarter. Delinquency rates on both installment credit and mortgages are also at or near postwar highs. Debt service—the interest charges on auto loans and on mortgages—too is at a new high at 11.1 percent of income, according to a proxy measure estimated by Shearson Lehman Brothers.
- Real disposable income is no longer growing rapidly. Over the next year, only a 2.4 percent rise can be expected. No further stimulus from tax reductions is in prospect.
- Household net worth, defined as the difference between household financial and physical assets and household liabilities, expressed in real terms, will be growing more slowly than previously.

CONSUMER FORECASTS

	Actual 1984	Est. 1985	Projected 1986
Real Consumption (% change)	5.3	3.9	2.1
Durables (% change)	13.1	7.5	0.0
Nondurables (% change)	4.6	2.4	1.7
Services (% change)	3.2	4.0	3.3
Auto sales (mill. units)	10.4	10.8	10.5
Retail sales (current $)	10.5	6.3	3.8
Real disposable income (% change)	6.7	2.2	2.4
Consumer price index (% change)	4.3	3.4	3.4
Mortgage and auto repayments as percent of income	45.9	44.2	43.5

• Consumer sentiment, as measured by the University of Michigan Survey index, is expected to moderate in the months ahead.

Why No Downturn?

No collapse or sustained decline in household spending should be expected, however, so long as inflation rates remain relatively low. Employment growth has been substantial, with three million new jobs created over the past year. Most of these have been in services where incomes are lower, but nevertheless jobs seem secure. In general, households seem reasonably optimistic about the future and plan to sustain spending. Other reasons include the stability expected for interest rates and the fact that the consumer balance sheet, while worsening considerably, has not deteriorated enough to cause an outright decline in spending.

Several major risks are present in the economy. One is the personal savings rate, which remains a puzzle. A sudden increase in the personal savings rate to 4 or 5 percent would mean a precipitous drop in consumer spending and, probably, a recession. Other major uncertainties for consumer spending lie in the possibility of tax reform and in negotiations over the budget in Washington. Tax reform, with its reductions in tax rates for consumers, would likely stimulate consumer spending more than is currently expected for 1986. Another tightening of the budget, if accompanied by monetary easing, would be likely to lower interest rates and raise equity prices, which should bring a strong response in consumer spending, especially in the interest-rate sensitive areas.

The Outlook for Capital Spending

Adrian T. Dillon

The growth of capital spending in the current economic expansion to date has been "out of bounds" compared with previous historical experience. Based on the Commerce Department's preliminary third-quarter numbers, fixed investment has risen over 35 percent since the economic trough in late 1982. This is almost double the 19-percent average increase experienced to this point in previous post-World War II expansions, and 10 points faster than the previously most rapid experience.

More recently, however, the pace of this capital spending "boom" has slowed sharply: Investment has risen at less than a 2½-percent annual rate since last year's fourth quarter and, in fact, spending has dropped in two of the past three quarters. After its extraordinary performance earlier in the cycle, is capital spending now "regressing toward the mean" of past historical performance, suggesting substantial weakness ahead? I think not. Most of the volatility in capital spending this year has been due to the weakness in office and computing machinery, which now represents 26 percent of total capital equipment spending. Excluding computers, total spending for producers durable equipment this year has risen at a very steady 4.8-percent annual rate.

Looking ahead, capital spending should support but not lead overall economic growth, rising 3½ to 4 percent during 1986. Perhaps more important, various categories of capital spending will perform far differently from the overall average. Capital equipment spending should rise 4 to 5 percent driven by an 8 to 10 percent rebound in "high tech" spending: Computer purchases should be up 10 to 15 percent, while spending on communications equipment should rise about 10 percent. Other categories of equipment spending should fare less well, however. Purchases of mobile equipment, after a 5 to 6 percent increase this year, should be down somewhat during 1986, due to modestly lower auto and truck purchases and to a sharp decline in commercial aircraft shipments. Purchases of stationary equipment (machine tools, special and general industry equipment, and transmission and distribution equipment) will follow the path of stagnant manufacturers' capacity utilization, rising about 2 percent next year after a 3 percent rise in 1985.

Adrian T. Dillon

No relief from pervasive global competition.

Categories of nonresidential construction (nearly one-third of total capital spending) will show similarly divergent trends. Commercial and industrial construction has been booming, with a 19-percent increase in value put in place this year, following 1984's 28-percent rise. However, office vacancy rates now average about 16 percent nationwide and new office construction contracts are beginning to weaken; office construction will be flat at best next year, and sharply lower in 1987. Store construction, on the other hand, should continue to show

good gains, following the trends of housing starts and completions. Finally, industrial construction, which has been very flat recently, should continue that pattern into 1986. Overall, after a 15.5-percent gain last year and a 10 percent expected rise in 1985, total nonresidential construction should be up 2 to 3 percent during 1986.

Answering the Pessimists

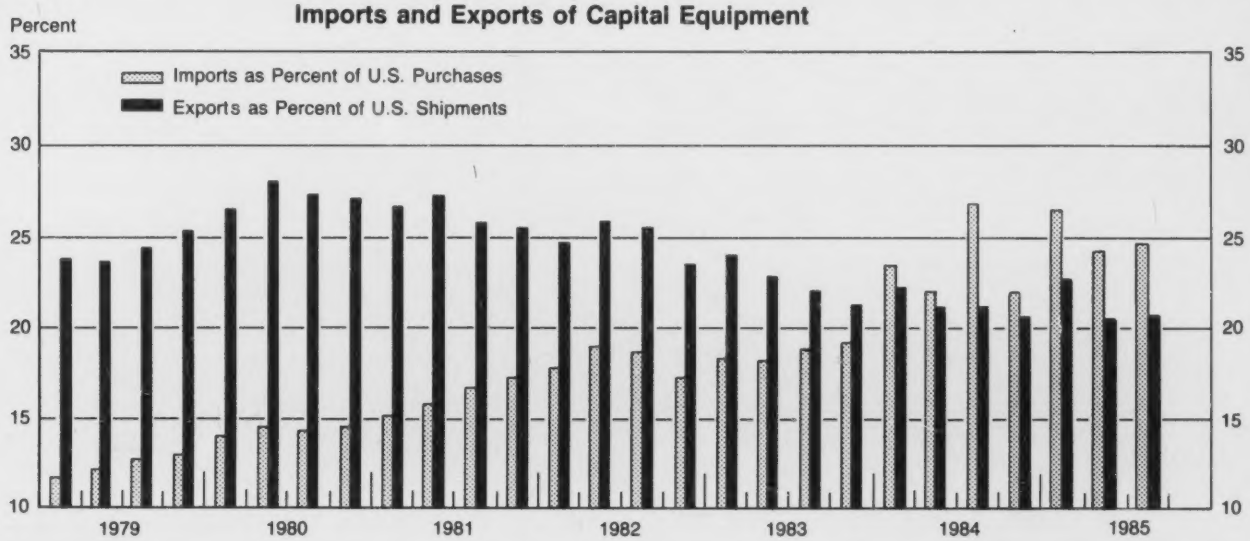
Looking at the determinants of capital spending, pessimists about the investment outlook generally point to two factors that could depress spending over the next year, even assuming that the general expansion continues: First, that current capacity in place is more than sufficient to handle a modest pickup in growth; and, second, that spending will be constrained by the year-long trend of declining after-tax corporate profits. Both arguments contain elements of truth, but should be considered in a broader context.

First, it is true that manufacturers' operating rates have been declining over the past year, tracking closely the trend of declining manufacturing employment. It is important to remember, however, that we are having a sharply bifurcated expansion, with a 1-percent annual decline in manufacturing employment over the past year more than offset by a 4-percent average growth in services employment. Manufacturing today represents only 19 percent of total employment and about 25 percent of total output. And, while demand for capital goods by manufacturers may be flat over the next year, that represents less than one-third of typical capital goods demand. It seems reasonable to assume that the trend of capacity utilization in services more closely tracks the very steady 4-percent growth of employment, and that sustained demand from that 70 percent of the economy should support modestly higher overall capital spending.

Looking at the impact of profits on capital investment, it is important to remember that reported after-tax profits may vary dramatically from economic profits and from operating cash flow. Historically, there has been a poor correlation between after-tax profits and fixed investment; capital spending has been much more closely related to total cash flow, which includes depreciation expenses, inventory-valuation adjustments, and, in recent years, the very substantial positive difference between book and economic depreciation. With profits also expected to be modestly higher next year, there should be no financial constraints on a modest rise in investment spending.

Three to five percent growth next year may be too optimistic a forecast, however, for real U.S. *shipments* of capital goods, because there will be no relief from increasingly pervasive global competition. Since 1980, imports have risen from about 14 percent of U.S. purchases of capital goods to about 25 percent; over the same time period exports as a percent of U.S. shipments have fallen from 27 percent to below 21 percent (see chart). Consequently, while the "boom" in U.S. capital goods *purchases* has brought spending to a level 24 percent above its previous cyclical peak, U.S. *shipments* of capital goods remain no higher than five years earlier. Unless the U.S. dollar falls sharply further in the months ahead or the growth of foreign economies picks up sharply, U.S. manufacturers of capital goods will find it very difficult to achieve 3 to 5 percent growth in the year ahead.

Imports and Exports of Capital Equipment



Housing and Housing Finance

Lyle E. Gramley

The easing of monetary policy that got under way in the Fall of 1984 has had less effect on housing activity than many forecasters had anticipated. Mortgage interest rates have fallen about two percentage points from their peaks in 1984, and might have been expected to push housing starts into the 1.8 to 2.0 million unit range at annual rates. Starts *have* increased significantly from their trough in October, 1984, but they reached a peak of around 1¾ million units at an annual rate in early 1985, and have actually come down somewhat since then. Residential building permits, however, have remained on a plateau, and sales of new homes have risen somewhat further.

Lyle E. Gramley

Tightening of mortgage standards will limit homebuilding.

This rather limited response of housing to declining mortgage interest rates may partly reflect continued relatively high real interest rates, home buyers' reluctance to take on the interest-rate risk associated with ARM's, and the reduced attractiveness of houses as an investment in an environment of relatively stable house prices. The largest factor, however, appears to be the tightening of underwriting standards in the residential-mortgage-credit field that got under way, coincidentally, at about the time that mortgage interest rates began to fall. Potential home buyers found mortgage credit available at lower cost, but fewer of them were able to qualify for loans.

Private mortgage insurers, facing rising foreclosures and larger payouts on mortgages covered by their guarantees, began to insist on higher quality mortgages in the portfolios that they accepted for insurance. Even more importantly, mortgage banking companies—whose principal source of income is from servicing mortgage portfolios—were experiencing markedly increased servicing costs because of rising delinquencies, and responded by adopting stricter underwriting standards, particularly lower loan-to-value ratios.

These developments began in the conventional mortgage market, but gradually spread to the market for government-guaranteed mortgages as well. Further impetus to the tightening of standards occurred in August, 1985, when FNMA announced a general tightening of standards on the mortgages it would purchase.

At today's mortgage interest rates, there is little basis for anticipating a marked improvement in housing production. In coming months, housing starts should rise relative to permits, regaining a more normal relationship between these two series. But the tightening of underwriting standards, which has yet to run its course fully, will limit any substantial further improvement in housing activity.

The financial environment for housing and housing finance is expected to remain relatively favorable in 1986. Interest rates are expected to be stable to declining moderately in the first half of the year, when the economy is expected to grow slowly, but to begin turning up in the second half with a strengthening economy. By the fourth quarter of 1986, however, mortgage interest rates are expected to be only marginally above the levels of a year earlier. In such an environment, housing starts in 1986 should remain fairly close to 1985 levels, acting as a supporting factor for the overall economy, but not as a significant source of stimulus.

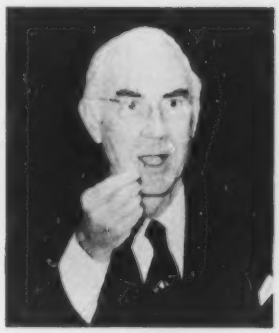
Capital Markets in Unchartered Waters

Daniel S. Ahearn

The psychology of the U.S. credit and capital markets has recently improved, and stock and bond prices have risen correspondingly. The better tone reflects a widespread belief that further easing of Federal Reserve monetary policy is imminent, and an expectation that coordinated intervention in the foreign-exchange market can lower the value of the dollar without causing any damaging side effects such as a diminution of foreign-investors' interest in U.S. securities. Psychology can dominate any market for a time, but whether this optimistic mood will last beyond the short term depends on whether these expectations are borne out.

Further, the current low level of inflation is comforting to the markets which, for the time being, are paying little attention to the build-up in traditional precursors of future inflation: high monetary growth, large budget deficits, a sinking foreign-exchange value of the currency. The equity market has benefited from a supply-demand improvement caused by the massive substitution of debt for equity in financing mergers and buyouts, and appears unconcerned by the greater vulnerability to economic adversity that the increased leverage implies. Meanwhile, in a broader context, the internationalization of the U.S. capital market, the enormous number of new capital market instruments not yet tested by adversity, and the unprecedented scale of demands on the market have introduced new complexities into any appraisal of the outlook. In summary, the credit and capital markets appear reasonably satisfied and hopeful about current developments and unconcerned about less constructive implications that lie just below the surface or just over the horizon.

The reality is that the U.S. capital market is in uncharted waters. No country on earth has ever run budget deficits on a $200-billion-a-year scale. No country before has ever had a $140-billion trade deficit. At the same time, traditional relationships no longer seem to apply. In the past, countries with budget and trade deficits typically saw their currencies weaken substantially. Yet the foreign-exchange value of the dollar doubled over the past four years, a time when our budget and trade deficits were mushrooming. The rate of inflation has not risen cyclically in this expansion as it usually does, in good part because the strong dollar led to a flood of low-priced foreign imports. Interest rates, which usually rise late in the cycle, are lower today than they were in the recession trough. This reflects continuing low inflation and, more importantly, the fact that the Federal Reserve has kept money easy to prevent the adverse impact of the strong dollar on the U.S. industrial sector from causing a business recession and precipitating a crisis among weak domestic and international debtors. The Fed's easy-money policy, in turn, has accommodated a plethora of mergers and leveraged buyouts whose common denominator has been enormous recourse to debt, thus producing still more vulnerable debt structures.



Daniel S. Ahearn

Sunny, but storm clouds developing.

In the face of all this, the U.S. credit and capital markets have functioned impressively. The S&P 500-stock average is up about 80 percent from its 1982 low, well in excess of most post-World War II bull-market gains. Bond yields have dropped nearly 400 basis points from their 1984 yield peaks, the biggest nonrecession yield decline in history. With all this behind them, the markets appear extended and could be volatile in responding to changes in fundamentals.

The most important fundamental is probably the outlook for the economy. If evidences of a near-term recession should develop, as many expect, the stock market would probably drop sharply, commodity prices and bond yields would come under new downward pressure, and a new bull market in bonds would get under way with a subsequent beneficial effect on stock markets. However, a persuasive case can be made for the U.S. economic expansion continuing well into—if not throughout—1986. Such further economic expansion presumably would mean continuing strong credit demands on the credit and capital markets.

Whether such credit demands could continue to be accommodated without raising interest rates probably depends most importantly on the behavior of foreign investors. It was foreign investors' eager appetite for U.S. securities over the past three years that supplemented U.S. domestic savings and prevented record budget deficits and record private credit demands from raising U.S. interest rates. It was also foreign investors' strong demand for U.S. securities that kept the dollar high despite an unprecedented U.S. trade deficit. And it was large volumes of low-priced imports encouraged by the high dollar that took away price-raising ability from U.S. business and kept U.S. inflation at recession levels, despite an easy Federal Reserve monetary policy and an unprecedented budget deficit.

Thus, whether foreigners will continue to be aggressive buyers of U.S. securities is an important and still unanswered question. In the past three years, foreigners have had not only large appreciation on their portfolios of U.S. securities, but also very sizable gains because of the rise of the dollar. How

will they react to the exchange losses that are following the recent decision of the United States and the four major industrial nations to reduce the foreign-exchange value of the dollar? Japanese investors, who were buying U.S. bonds for a four or five percentage point income advantage, suffered a fifteen point exchange loss in the first three weeks after the meeting, wiping out three to four years of extra income. European investors still remember much larger dollar-exchange losses in the late 1970's, losses that in many cases exceeded their returns from U.S. securities. If foreign investors become less eager buyers of U.S. securities, this alone would be an important force for higher U.S. interest rates in the years ahead, since foreigners have been supplying about $130 billion a year to the U.S. capital market—equal to about two-thirds of the U.S. budget deficit or about one-fifth of total annual U.S. gross yearly investment in plant, equipment and inventories.

More Volatility

It is potentially significant that the character of overall demand for credit appears to be changing in ways that suggest greater interest-rate volatility. In the past, when interest rates rose sharply, many prospective borrowers postponed their issues, reducing their demand for credit and limiting the rise in rates. In economists' terms, the demand for credit was elastic with respect to interest rates. But now there are reasons to believe credit demand has become more inelastic.

The Federal Government, which has always been an inelastic borrower (it pays whatever interest rate is needed to fill its needs), now accounts for a greater share of total borrowing, thus increasing average interest-rate inelasticity. More important, the corporate sector has become increasingly inelastic in its demand for funds. The major reason is the much more leveraged position of the business balance sheet, a high proportion of which is short-term debt, and the lower percentage of cash to liabilities. Thus, many companies no longer have the luxury of postponing debt issues if rates seem high. Short maturities must be refinanced, regardless of the interest-rate level, if bankruptcy is to be avoided. Moreover, the increasing number of weak credits in a variety of industries and sectors mean more necessitous borrowers who have to have money regardless of rate. With credit demand more inelastic with respect to interest rates, rates will rise more for any given rise in credit demand.

The U.S. capital market outlook is also complicated by important legislative uncertainties. It is still unclear whether, when and in what form the President's tax-reform proposal will be enacted, but the economy and the markets could be affected substantially. The budget-deficit problem has stimulated the Gramm-Rudman-Hollings amendment aimed at eliminating the deficit over a six-year period. The amendment will probably be enacted to avoid a debt crisis, but it has not had adequate review: Its consequences are not at all clear, and even its constitutionality is suspect.

Summing all this up, it seems likely that recent bond-market optimism will be severely tested before long if business activity holds up, the Fed does not cut the discount rate, and the dollar declines further. Equities should benefit so long as bond-market optimism is high, and should be supported for a while when interest rates begin to rise again by the outlook for better earnings as a result of a lower dollar and the encouragement of better-than-expected business activity over the next few quarters. However, legislative uncertainties are unlikely to be resolved and, hence, will continue to be a force for volatility in the credit and capital market. Thus, it is possible to see some developing storm clouds beyond a reasonably sunny near term.

Equity Market Outlook

Robert G. Wade, Jr.

The outlook for the economy is positive, in our view. We expect GNP growth to pick up to *at least* trend-line levels (3 percent or so) during 1986 and, hopefully, beyond. Within this environment, we expect inflation to remain calm and the exchange value of the dollar to move irregularly lower.

Federal Reserve policy has now been accommodative for over a year and continues to be benign, and these efforts should result in continued economic growth. We feel the chances of a recession are low in the absence of a restrictive monetary policy. With inflation pressures subdued and continued concerns about economic growth being expressed, any changes in current Fed policy may be on the side of ease.

The prospects we see for the equity market are, of course, closely related to our outlook for the economy. As is well known, the equity market typically turns south in advance of an oncoming recession, generally with a lead time of three to nine months. However, since we do not see the seeds of recession being planted as yet, the cyclical support for equities remains in place.

We find that equity-market returns are more closely related to Federal Reserve policy (and the associated interest-rate and liquidity structure) than to any other single factor. As noted above, these factors are positive, as they have been for the past year or so.

In addition to monitoring the cyclical environment, we also pay considerable attention to what other investors are saying and doing, with an eye to being contrary. On this score, our equity-market outlook has improved in recent weeks, primarily because our data reflect an increase in investor worries and pessimism. Consequently, the concerns that exist today—in contrast to a more ebullient outlook that was prevalent in the Spring—are lending support to our relatively sanguine outlook for the equity market.

Many have noted that the supply of equities has shrunk to an unprecedented degree over the past two years, due to mergers, leveraged buy-outs, share-repurchase programs, and so forth. This reduction of supply should, of course, have favorable implications for the equity market. In addition, if one considers that institutions are holding their highest cash reserves since year-end 1984 (reflecting the aforementioned concerns about the market), and that individuals are becoming increasingly less satisfied with their reduced returns on fixed-income instruments (particularly shorter-term securities), a bullish supply-and-demand case can be built for equities.

If we considered the stock market to be cheap, a very bullish case for equities could be made, in our opinion. Unfortunately, on an absolute basis, we think that the equity market is fairly valued, at best. This situation reflects primarily the fact that stock prices (S&P 500) are up about 90 percent since July, 1982. (Over the long run, stock-market prices grow in line with the nominal economy. Clearly, then, the rates of gain experienced in recent years are unsustainable.) Another factor with an impact on our valuation case is the fact that, while stock prices have soared, the supporting growth of dividends and earnings has been below average.

Robert G. Wade, Jr.

The equity market is fairly valued.

In addition to no longer being cheap on an absolute basis, the demand for stocks continues to be affected by relatively attractive bond yields. For example, we currently expect equities to provide approximately a 12-percent return over the long run. This compares with bond yields that are only 1 to 2 percent lower. Consequently, many investors, particularly pension funds, are not excited about increasing their equity exposures relative to the risk involved.

Our outlook on fixed-income investments is not as favorable as our opinion about the prospects for the equity market. To be sure, the lack of economic pressures, (e.g., still slightly falling capacity utilization), the lack of financial pressures (e.g., a positive slope of the yield curve), and an absence of inflation pressures (e.g., a flat producer price index this year), all auger well for the bond market. In addition, the still relatively high level of real interest rates should continue to attract capital to the fixed-income markets. However, continued economic growth should, at some point, increase credit demands and possible concerns about inflation. Hence, we would not be surprised if the fixed-income markets came under pressure at some point over the next year or so. In the meantime, with current negative pressures relatively absent, the bond market could perform reasonably well.

All in all, we are recommending that equity exposure levels be above average and about midway between a "normal" exposure and a fully aggressive commitment. We are approximately neutral on bonds. Continued economic growth will be the key ingredient for equities to outperform fixed-income investments.

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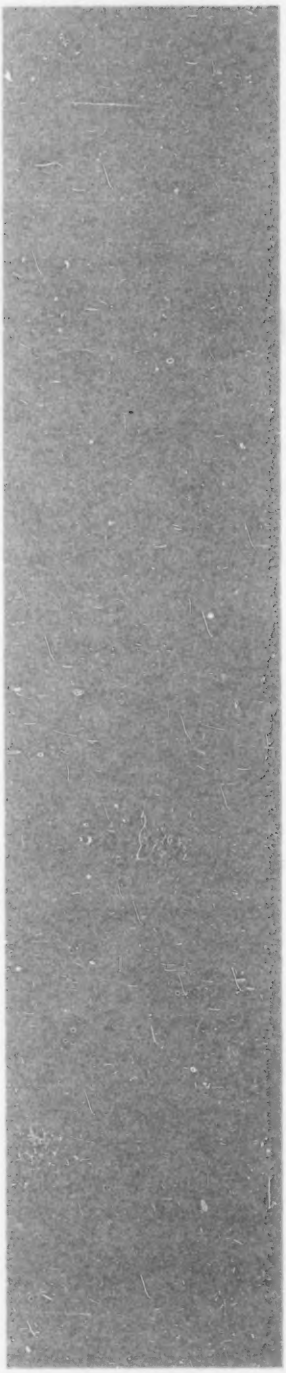
Research Bulletin

No. 191



The Conference Board

Top Executive Compensation in U.S.-Based Multinationals

1986 Edition

by Harland Fox and Charles A. Peck

Management Summary

- For the second consecutive year, this survey of top executive compensation practices in U.S.-based multinational manufacturing companies did not reveal marked differences from the practices of the larger spectrum of U.S. manufacturing companies.

- For these multinationals, 1984 total compensation was 11 percent greater than in 1983. Bonuses paid for 1984 were 14 percent greater than 1983 awards, and 1984 base salary was up nine percent over 1983.

- Stock option plans were reported by 93 percent of the surveyed companies. Half reported long-term performance share or unit plans. One-quarter had plans for awarding shares of restricted stock.

Human Resources Program

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The Conference Board
Research
Bulletin

Top Executive Compensation in U.S.-Based Multinationals

1986 Edition

For the second consecutive year, The Conference Board has examined the compensation paid top executives in a sample of internationally involved United States manufacturing companies. This is in response to the continuing interest in the compensation practices of U.S.-based multinational companies as compared with the practices of those companies operating only within the domestic United States.

This bulletin looks at the compensation of the five highest paid executives in 122 multinational companies. For ease of comparison, the information is presented in the same general format as The Conference Board's annual study of top executive compensation.[1] This larger study is based on a sample of 475 U.S. manufacturing companies.

It is hoped the information provided here will prove helpful to executives involved with multinational operations. Probably the most general conclusion to be drawn from the data is that compensation practices in U.S.-based multinationals do not differ markedly from those of the larger spectrum of U.S. manufacturing companies.

The Multinational Companies

A multinational company, for the purpose of this study, is any manufacturing company that meets any two of the following criteria:

(1) Thirty percent or more of total sales are outside the United States.

(2) Foreign sales are at least $250 million.

(3) Manufacturing operations controlled by the U.S. parent are located in at least five countries.

Based on an analysis of the overseas operations of some 2,000 manufacturers, 189 met at least two of the criteria.

Data on the 1984 compensation of their five highest paid executives were obtained for 122 of these manufacturers, from a study of 475 manufacturers with sales of $100 million or more whose stock is listed on the New York or American Exchange. These multinational companies are classified in the tabulation below according to their 1984 sales volume.

	Companies	
1984 Sales	Number	Percent
$10 billion or over	20	16%
5—9,999 billion	17	14
4—4,999 billion	12	10
3—3,999 billion	15	12
2—2,999 billion	13	11
1—1,999 billion	23	19
500—999 million	15	12
100—499 million	7	6
Total	122	100%

Median sales for the group are $3.2 billion, with the middle half ranging between $1.4 billion and $6.1 billion.

Pay Trends

Total compensation for 1984 (which includes bonus awards) was 11 percent greater than in 1983 as illustrated by the median change for the chief executive officer position in companies for which both 1984 and 1983 total compensation data were available. In these 105 companies, the median change in total compensation for the chief executive officer position was 11 percent, with the middle half ranging from an increase of five percent to 21 percent.

For 17 percent of these chief executive officer positions, total compensation for 1984 was lower than for 1983, and two percent (two cases) registered no gain. Among the 81 percent that show an increase, the median increase is 14 percent, with the middle half ranging between eight and 28 percent.

Some of the increase in total compensation is the result of increased bonus payments. Among the 87 companies that paid a bonus to the chief executive position in both 1984 and 1983, the median increase was 14 percent, with the middle half ranging from an increase of three percent to 35 percent. Among the 78 percent that got a larger bonus, the median increase

[1] See Harland Fox and Charles A. Peck, *Top Executive Compensation 1986 Edition*, The Conference Board, Report No. 875, 1985.

was 20 percent, with the middle half ranging from 10 to 44 percent.

Total compensation also increased because of increases in base salary. Among the 104 companies for which both 1984 and 1983 base salary were available, the median increase for the chief executive position was nine percent, with the middle half ranging between a five percent and a 12 percent increase. For eight percent of these chief executive positions, salary was lower in 1984 than in 1983, and for 10 percent it was unchanged. Among the 82 percent that received an increase, the median is 10 percent, with the middle half between seven and 13 percent.

Total Compensation

For each multinational manufacturer, compensation data were obtained for the five highest paid executives without regard to title or function. The highest paid executive is almost always the chief executive officer, and the second highest paid, the chief operating officer.

The 1984 *total compensation* of each of the five highest paid executives in each company is measured as the sum of the 1984 salary and 1984 bonus award. The median and middle 50-percent range of the total compensation of the chief executive officers and the other four executives are shown below.

Compensation Rank	1984 Total Compensation	
	Median	Middle 50 Percent Range
Highest Paid	$723,000	$525,000 to $925,000
Second	462,000	320,000 to 622,000
Third	380,000	263,000 to 485,000
Fourth	309,000	243,000 to 427,000
Fifth	293,000	220,000 to 383,000

As the regression lines of Chart 1 illustrate, there is a positive relationship between the level of total compensation and sales volume for all five executives. The correlation coefficients for the five lines are, respectively: 0.84; 0.81; 0.83; 0.83; and 0.84.

The regression lines on the chart can be used to determine the average compensation of an executive at any level of company sales, either by a direct reading from the chart or by using the regression formulas below. (In these formulas, Y is total compensation stated in *thousands* of dollars; that is, $532,000 is 532. X is sales volume stated in *millions* of dollars; that is, $248,000,000 is 248.)

Rank	Regression Formula	r^2
Highest paid	$\log Y = 1.8807 + 0.2734 \log X$	70%
Second	$\log Y = 1.6523 + 0.2877 \log X$	66
Third	$\log Y = 1.5409 + 0.2922 \log X$	69
Fourth	$\log Y = 1.5118 + 0.2829 \log X$	69
Fifth	$\log Y = 1.4271 + 0.2957 \log X$	71

Although total compensation and sales are highly related, company size is not the sole determinant of total compensation levels. As the "coefficients of determination" (r^2) above indicate, the variation in sales volume statistically explains only 66 to 71 percent of the variation in total compensation of the five top-paid executives.

The ratio of the total compensation of each executive to that of the chief executive officer is shown below.

Compensation Rank	Total Compensation as a Percentage of CEO's Total Compensation	
	Median	Middle 50 Percent Range
Second highest	69%	61% to 76%
Third highest	53	47 to 60
Fourth highest	45	41 to 53
Fifth highest	42	37 to 47

Salary

The median and middle 50 percent range of the *base salary* of the five highest paid executives are shown below.

Compensation Rank	1984 Base Salary	
	Median	Middle 50 Percent Range
Highest paid	$450,000	$381,000 to $541,000
Second	314,000	245,000 to 393,000
Third	250,000	202,000 to 305,000
Fourth	213,000	183,000 to 275,000
Fifth	200,000	162,000 to 245,000

Again, there is a strong relationship between the level of base salary and company sales volume, as illustrated on Chart 2. The correlation coefficients for the five lines are, respectively: 0.83; 0.78; 0.81; 0.80; and 0.81. The equations for these lines are shown below.

Rank	Regression Formula	r^2
Highest paid	$\log Y = 1.9568 + 0.1985 \log X$	69%
Second	$\log Y = 1.7617 + 0.2072 \log X$	61
Third	$\log Y = 1.6489 + 0.2133 \log X$	65
Fourth	$\log Y = 1.5836 + 0.2150 \log X$	64
Fifth	$\log Y = 1.5462 + 0.2157 \log X$	66

As the "coefficients of determination" (r^2) indicate, the variation in sales volume statistically explains 61 to 69 percent of the variation in base salary of the five top-paid executives. These coefficients are essentially similar to the coefficients for total compensation shown earlier.

Chart 1: Total Compensation: Five Highest Paid Executives

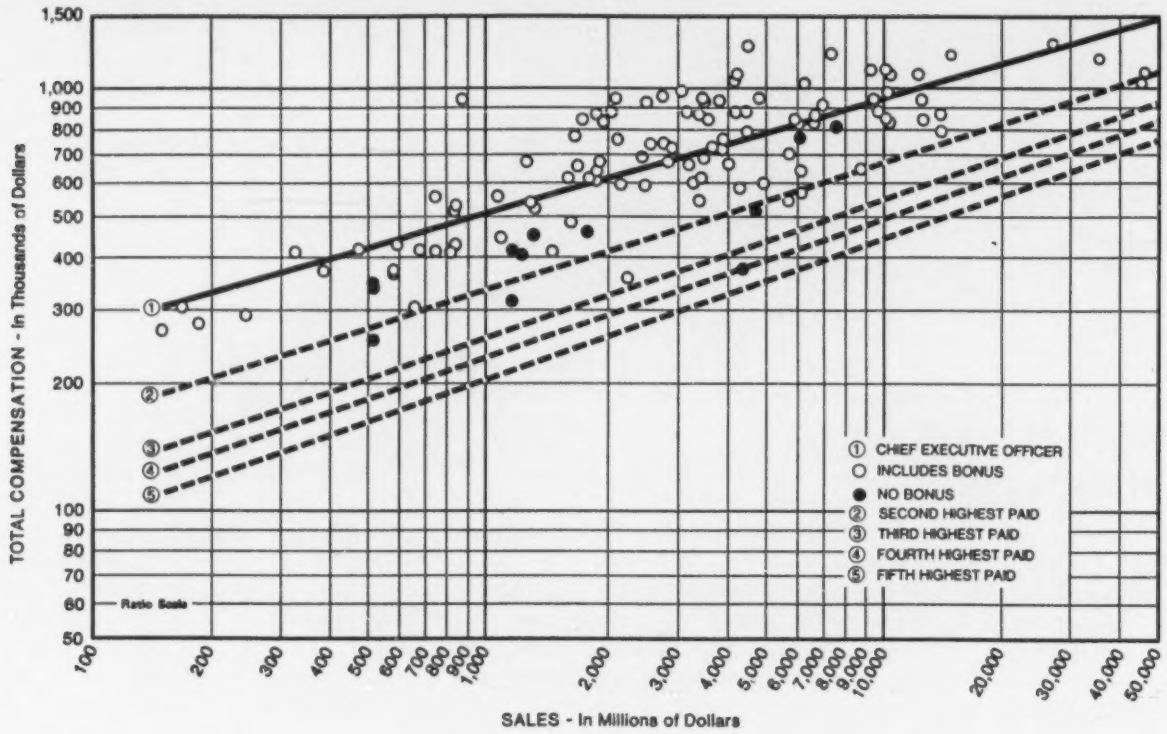
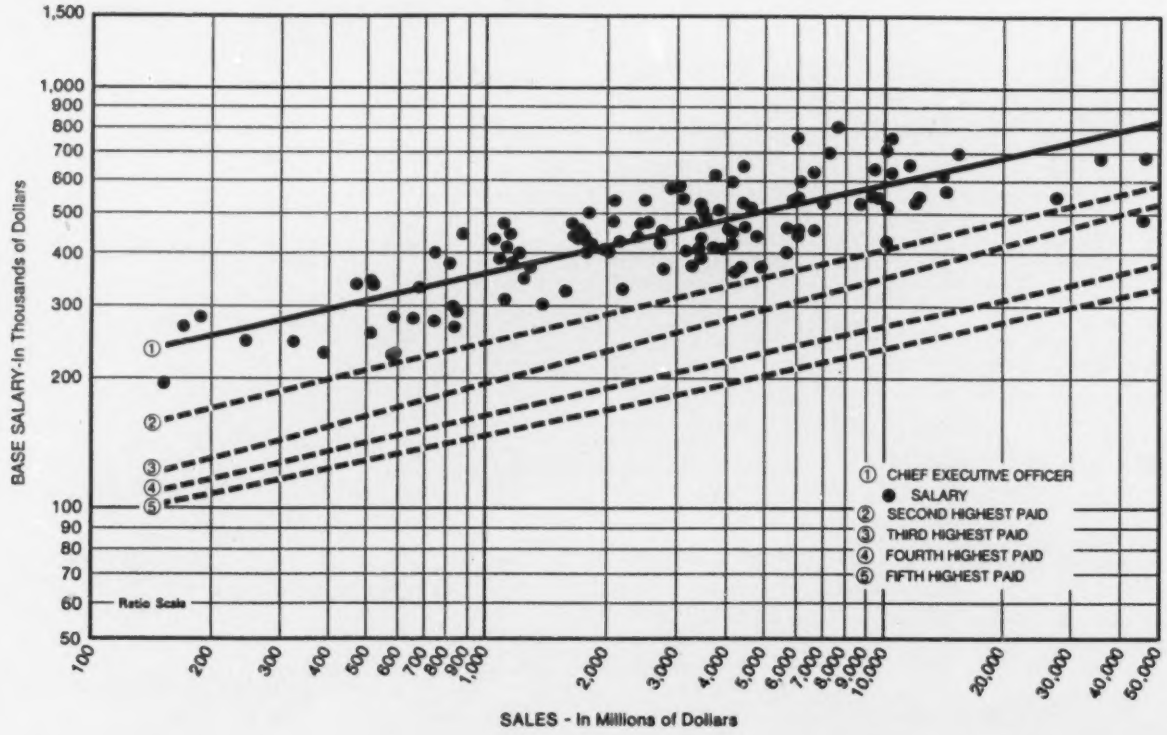


Chart 2: Base Salary: Five Highest Paid Executives



The ratio of the base salary of each executive to that of the chief executive officer is shown below.

Compensation Rank	Base Salary as a Percentage of CEO's Salary	
	Median	Middle 50 Percent Range
Second highest	71%	61% to 77%
Third highest	54	49 to 63
Fourth highest	48	43 to 54
Fifth highest	44	39 to 50

These base-salary ratios are essentially the same as the total compensation ratios.

Annual Bonus Awards

All but six of the 122 multinational manufacturers have an "annual" bonus plan; that is, a plan that pays a year-end bonus that is based on that year's corporate financial performance. In general, the bonus award tends to increase as a percentage of salary as base salary increases. This explains, in part, why the median award for the chief executive officers, 62 percent of salary, is larger than that for the second highest paid, 57 percent; the third highest paid, 53 percent; the fourth highest paid, 50 percent; and the fifth highest paid, 47 percent of base salary. (See Table 1.) Similarly, bonus awards for each of the five executives tend to increase as the size of the company increases, as does base salary. (See Table 2.) Data from the table are derived from the regression equations below which are based on the pay of executives in 106 companies that paid a bonus. (The coefficients of determination are in parentheses.)

	Total Compensation	r^2
Highest paid	$\log Y = 1.9416 + 0.2605 \log X$	(72%)
Second	$\log Y = 1.6997 + 0.2784 \log X$	(67)
Third	$\log Y = 1.5966 + 0.2810 \log X$	(71)
Fourth	$\log Y = 1.5753 + 0.2690 \log X$	(71)
Fifth	$\log Y = 1.4744 + 0.2858 \log X$	(72)
	Base Salary	
Highest paid	$\log Y = 1.9639 + 0.1952 \log X$	(70%)
Second	$\log Y = 1.7625 + 0.2058 \log X$	(61)
Third	$\log Y = 1.6676 + 0.2077 \log X$	(65)
Fourth	$\log Y = 1.6026 + 0.2089 \log X$	(64)
Fifth	$\log Y = 1.5543 + 0.2122 \log X$	(67)

Long-term Performance Share/Unit Plans

In recent years, some companies have adopted incentive plans for executives in which the reward is based on the attainment of specified *long-term* corporate financial performance goals, in contradistinction to the annual bonus plans that are based on a single year's corporate performance.

Under these plans, top executives are given a contingent award of company shares or, more commonly, performance units at the beginning of a performance period of three, four or five years. The actual value of the award is determined by how closely specified corporate financial performance objectives (usually growth in earnings per share) are met over the course of the performance period. As a rule, a new perfor-

Table 1: 1984 Annual Bonus Awards, and 1983 Median Bonus

1984 Bonus Awards (Percent of Salary)	*Chief Executives*		*Second Highest Paid*		*Third Highest Paid*		*Fourth Highest Paid*		*Fifth Highest Paid*	
	Number	*Percent*	*Number*	*Percent*	*Number*	*Percent*	*Number*	*Percent*	*Number*	*Percent*
100% or more	13	12%	10	9%	8	7%	8	7%	10	9%
90—99	4	4	2	2	2	2	2	2	2	2
80—89	9	9	5	5	5	5	4	4	3	3
70—79	17	16	16	15	12	11	7	6	10	9
60—69	16	15	12	11	14	13	15	14	11	10
50—59	14	13	21	19	18	17	20	18	14	13
40—49	12	11	17	16	18	17	20	18	22	20
30—39	8	7	11	10	15	14	17	16	13	12
20—29	9	8	7	7	9	8	10	9	14	13
Less than 20%	7	6	7	7	8	7	6	6	10	9
Total	109	100%	108	100%	109	100%	109	100%	109	100%
Median Bonus	62%		57%		53%		50%		47%	
Middle 50% Range	43–78%		41–72%		39–70%		36–65%		32–69%	
1983 Median Bonus	58%		55%		50%		50%		44%	

Table 2: Bonus Awards (as Percent of Salary) by Company Size

	Sales Volume		
Executive	*$1.4 billion*	*$3.2 billion*	*$6.1 billion*
Chief Executive Officer			
Bonus (% Salary)	53%	61%	68%
Salary	$378,000	$445,000	$504,000
Second Highest Paid			
Bonus (% Salary)	46%	55%	63%
Salary	$257,000	$305,000	$348,000
Third Highest Paid			
Bonus (% Salary)	45%	53%	61%
Salary	$209,000	$249,000	$284,000
Fourth Highest Paid			
Bonus (% Salary)	45%	53%	59%
Salary	$182,000	$216,000	$247,000
Fifth Highest Paid			
Bonus (% Salary)	41%	50%	58%
Salary	$167,000	$199,000	$228,000

mance period is created each year or, in some cases, every two years; that is, performance periods overlap.[2]

About half (62) of the multinationals have a long-term performance share/unit plan. The plans are more common among the larger companies; for example, 65 percent of the 37 companies with sales of $5 billion or more have a plan compared with 63 percent of the 27 companies with sales of $3 to $5 billion, and 36 percent of the 58 companies with sales under $3 billion.

Twenty-six companies made a payment during 1984 to one or more of their five top-paid executives under these plans. Payments to 118 executives are shown below, converted to a percentage of their 1984 base salary.

Payment as	Executive	
Percent of Salary	Number	Percent
100% and over	27	23%
50—99	16	14
40—49	7	6
30—39	20	17
20—29	24	20
Less than 20%	24	20
Total	118	100%

[2] For an analysis of the characteristics of 89 of these plans, see Harland Fox, *Executive Incentives: Long-Term Performance Share/Unit Plans.* The Conference Board, Research Bulletin No. 132, 1983.

The median payment is the equivalent of 34 percent of 1984 salary, with the middle half of payments ranging between 21 and 94 percent of base salary.

Stock Option Plans

As a general rule, the long-term corporate goals on which performance share/unit plans are based are not stated in terms of an increase in the market price of company stock. Many are an attempt to get away from the vagaries of the stock market; either they are a substitute for a stock option or a complement to it.

By far the most common executive incentive plan, in which the reward is based on the long-term performance of the corporation, is the stock option plan that measures corporate performance solely by the market value of company stock. That is, an executive is given an option to purchase a specified number of shares of stock at a specified price (usually the market price on the date of the grant); the executive may exercise this option to buy during a specified period of time, usually over the ten years following the date of grant.

There are two types of corporate stock options as defined by current tax laws: the "nonqualified" option and the "incentive stock option" (ISO).[3] The major differences between an ISO and a nonqualified option are:

- Under an ISO, the executive is not taxed at the time the

[3] For an analysis of the characteristics of 189 plans, see Harland Fox, *Incentive Stock Option Plans.* The Conference Board, Research Bulletin No. 148, 1983.

option is exercised if the stock is held for a year (and at least two years from the date of grant). When the stock is sold, any gain is taxed at the long term capital gains rate.

- When a nonqualified option is exercised, the executive pays tax (at ordinary income tax rates with a top marginal rate of 50 percent) on the spread between the option price and current market value. Any further gain is taxed as a capital gain when the stock is sold.
- No individual may be granted ISO's amounting to more than $100,000 in any year. Nonqualified options may be granted in any amounts.
- ISO's must be exercised in the sequence in which they are awarded. For example, if one ISO was granted at $50 per share and a subsequent ISO at $40 per share, the second grant could not be exercised before the first one even if the current market value climbed back to $50 a share. Nonqualified options have no such restriction on the sequence in which they are exercised.

Ninety-three percent (109) of the 122 multinational manufacturers have a stock option plan, and 82 made stock option grants during 1984 to their top executives. A small group of companies granted *only* ISO's (5) or *only* nonqualified options (16); fifty-nine companies granted *both* ISO's and nonqualified options. The remaining two companies did not specify the type(s) of option granted. Among the 59 companies that granted both types of option, 35 used the nonqualified option only to make larger awards to those executives whose ISO grant reached the $100,000 limit noted above.

All 82 of the multinationals that granted options during 1984 provided information about the value of the option grant for one or more of their five top executives. (The value of the option is the number of shares multiplied by the market price at time of grant.) The size of the option grants for 396 executives is shown below, converted to a percentage of 1984 base salary.

Value at Time of Grant	Executives	
(Percent of Salary)	Number	Percent
400% or more	13	3%
300—399	10	3
250—299	17	4
200—249	20	5
175—199	12	3
150—174	25	6
125—149	36	9
100—124	47	12
75—99	62	16
50—74	94	24
25—49	48	12
Less than 25%	12	3
Total	396	100%

The median value of the option grant for these executives is 90 percent of base salary, with the middle half ranging between 61 and 148 percent. (It should be noted that grants are made each year by most companies.)

The median grant to chief executive officers (101 percent of salary) is higher than that for the second highest paid (94 percent); the third highest paid (91 percent); the fourth highest paid (90 percent); and the fifth highest paid (78 percent).

One or more of the five top-paid executives in 70 companies exercised a stock option during 1984. The net gain realized (current market value minus option price at date of grant) for 191 executives is shown below, converted to a percentage of 1984 base salary.

Gain at Exercise	Executives	
(Percent of Salary)	Number	Percent
400% or more	8	4%
300—399	5	3
200—299	12	6
150—199	7	4
100—149	16	8
75—99	15	8
50—74	19	10
25—49	49	26
15—24	27	14
Less than 15%	33	17
Total	191	100%

The median gain at exercise is the equivalent of 39 percent of base salary, with the middle half ranging between 21 and 95 percent of 1984 salary. In dollar terms, the gain ranged from less than $10,000 to almost $3 million. The median gain was $129,000, with the middle half ranging between $49,000 and $353,000.

Restricted Stock Plans

Restricted stock plans have two major characteristics: (1) The award is an outright grant of company shares; recipients do not have to buy the stock; (2) The shares are forfeitable and nontransferable until the executive completes a specified period of continued employment with the company. The restricted stock grant is, simply, a deferred bonus award, the payout of which is contingent upon continued employment; it is a set of "golden handcuffs" designed to retain selected executives.

This required period of continued employment until *all* shares are released to the executive is the "restriction period." It runs from one to ten years after the date of grant but, most commonly, five, three or four years, respectively. Generally, the executive can vote the shares and receive dividends during this restriction period. Dividends are taxed as received, as though they were additional salary. Similarly, when shares are released to the executive, they are taxed at the market value

on the date of release (not date of grant) and taxed as though they were additional salary.[4]

One-quarter (31) of the multinational manufacturers have a restricted stock plan. Twenty-four of them made an award during 1984. The awards for 103 executives are shown below, converted to a percentage of their 1984 base salary. For this purpose, the value of the award is market value at the time of the award.

Award as Percent of Salary	Executives	
	Number	Percent
200% or more	6	6%
100—199	13	13
40—99	28	27
30—39	6	6
20—29	16	16
Less than 20%	34	33
Total	103	100%

The median award is the equivalent of 34 percent of base salary, with the middle half of the awards ranging between 17 and 80 percent of salary.

[4] Most plans provide for "partial vesting" during the restriction period; that is, some part of the award is made available periodically prior to the end of the restriction period. For an analysis of 91 plans, see Harland Fox, *Restricted Stock for Executives.* The Conference Board, Research Bulletin No. 159, 1984.

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Research Bulletin

No. 183

The Conference Board
70th Anniversary

Financing Export Sales

by Francis A. Lees

Management Summary

- Among the financial problems that face exporters is that of controlling various risks: creditworthiness of customers; risks relating to currency and foreign exchange controls; and the economic and political stability of the customers' countries.

- Surveyed companies attempt to control these risks through more careful screening of buyers than is usual in domestic business; utilization of services offered by banks and other institutions that specialize in international trade; currency hedging; automatic adjustments in selling prices to compensate for adverse shifts in exchange rates; and invoicing in U.S. dollars.

- Exporters responding to this survey generally find that the services offered by commercial banks and other export service organizations are satisfactory. However, only a minority use export credit insurance offered by the Export-Import Bank, Foreign Credit Insurance Association and Overseas Private Investment Corporation.

- Most of the surveyed companies had established Domestic International Sales Corporations (DISC's) under the Federal tax legislation that was in effect from 1971 to 1984. The surveyed exporters made heavy use of their DISC's, most of them channeling 75% or more of their exports through these paper subsidiaries. Most sponsors found DISC's helpful in meeting competition but not absolutely necessary to exporting success.

- Most respondents planned to set up Foreign Sales Corporations (FSC's), a new type of subsidiary permitted under the 1984 Federal tax legislation, even though they regard FSC's as less satisfactory exporting vehicles than the old DISC's.

Financial Management Program

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The Conference Board
Research
Bulletin

Financing Export Sales

Introduction

For some years now, U.S. trade deficits have been the subject of considerable public and business discussion. At the same time, the pace of the trend toward internationalization of business has increased. With more companies interested in exporting, The Conference Board believed that it would be useful to survey a sample of companies already engaged in export trade in order to find out how they manage export trade and how satisfied they are with some of the alternative arrangements available to them.

While these data were being gathered, Congress repealed the provision of the Revenue Act of 1971 that permitted U.S. firms to set up paper subsidiaries (Domestic International Sales Corporations), popularly known as DISC's. The principal feature of the 1971 legislation was that a large share of income that would normally be subject to the corporate income tax was allowed to be deferred until the DISC's earnings were distributed to the parent company. This tax incentive was largely eliminated as part of the Tax Reform Act of 1984. Instead, Congress authorized companies to set up a new type of entity, a Foreign Sales Corporation (FSC). The same legislation permitted a modified form of DISC. This legislation is of particular concern to financial managers because of the questions of accounting for the previously deferred taxable income. Therefore, a second survey was conducted—specifically concerned with DISC-and FSC-related tax incentives.

The results of both brief studies are presented here as Parts I and II, respectively, of this paper.

Objectives of This Research Project

This research project was designed to help two groups of readers. One is composed of business people who are familiar with exporting in a general way but who wish to be brought up to date on current practices. The others are those who are just beginning to be involved with exporting and who need an introduction to the customs, services and incentives presently existing.

The research was limited to practical, day-to-day considerations in the financial management of the export function. Other aspects of exporting have been covered in the following Conference Board publications:

John Hein, *The Dollar and U.S. Exports: Some Q and A's*, The Conference Board, Research Bulletin No. 158, 1984.

Virginia Yorio, *Adapting Products for Export*, The Conference Board, Report No. 835, 1983.

Shirley Rhine. *The Impact of Regulations on U.S. Exports*, The Conference Board, Report No. 809, 1981.

Part I: Financial Management of Export Sales

The major purpose of the first survey was to examine the basic financial tasks that must be discharged in exporting, and to describe which are accomplished in-house and which are provided by others. (The companies responding are described in the box.) The services necessary to exporters are:

—Intelligence about the buyers, the economies and the foreign-exchange situations of the buyers' countries;

—Arrangements for the transfer of funds, including release of funds by the importer's central bank if there are exchange controls; discounting; and communication between the exporter's and the importer's banks.

—Provision of credit to the buyer by a commercial bank, a nonbank finance company, an international organization, or through money-market facilities. Some exporters extend credit on their own, just as some larger exporters and large banks self-insure against credit risks.

—Assembling and forwarding appropriate documents, a function in which banks are an important channel.

Organizing for Export Sales

Many of the 95 responding companies make use of more than one type of organization, with two-thirds reporting an export division or department within the company:

Organization	*Number of Firms (multiple responses)*
Export division or department within company	67
U.S. subsidiary corporation	26
Combination export manager	16
Export trading company	8
Other	17
	134

The second most frequently mentioned organizational format is a U.S. subsidiary, set up especially to engage in export transactions. In recent years, some of these subsidiaries have been set up as a response to the growth in countertrade. As more buying countries require that a supplier buy an equivalent amount of that country's goods and as countertrade arrangements become increasingly complicated, managing such trade can require very highly specialized skills.

Companies with smaller dollar volumes of exports frequently mention the combination export manager (CEM) as their organizational arrangement for exporting. CEM's provide a range of services that include establishing links with foreign buyers, reducing financial and other risks, providing documentation services, and arranging for the financing and shipping of merchandise.

Export trading companies (ETC's) are organizations registered under the Export Trading Act of 1982. Under this statute: (1) Companies may band together in what might be termed "export cartels"—but with immunity from U.S. antitrust laws; and (2) Banks are permitted to own businesses formed primarily for the purpose of exporting. ETC's have been in existence for too short a time to make any judgment as to why there are so few of them.

Among the other organizational formats reported are: (1) domestic division-level responsibility for exports; (2) a sales force organized by geographic regions; (3) export associations; (4) assignment of export-management functions to the company's sales manager; and (5) DISC's (Domestic International Sales Corporations).

Problems in Financing Exports

Among the problems that face exporters is that of various risks. In normal, domestic transactions, it is the purchaser's creditworthiness that has to be analyzed and assured. In

Sources of Information, Part I

The first questionnaire dealt primarily with the extent of the companies' export activities, their approach to minimizing export risks, the nature of the financial services they offer to foreign customers, and the institutions and agencies they use to help them in these tasks. Most of the questionnaires were answered by people with the titles of export manager or export director or variations thereof. Some had the rank of vice president.

Responses were received from ninety-five companies currently engaged in exporting. Of these, 57 are durable goods manufacturers; 25 manufacture nondurables; and the rest are suppliers of diversified products, distributors of manufactured parts, equipment and engineering service companies.

The responding companies represent a wide range of size categories, as measured by annual sales:

Annual Sales	*Number of Firms*
$5 billion or more	11
$1 billion – $5 billion	15
$500 million – $1 billion	7
$100 million – $500 million	28
Less than $100 million	34
	95

Roughly half of these exporters depend on foreign markets for 10 percent or more of their total sales:

Exports as Percent of Total Sales	*Number of Firms*
60-70%	1
50-60	3
40-50	2
30-40	8
20-30	12
10-20	19
0-10	44
Less than 10%	6
	95

international transactions, there are also the problems associated with currency and foreign-exchange controls, and with the economic and political stability of the buyer's country.

More usual problems are related to finding the appropriate method of payment (open account, letter of credit, or sale under collection) and negotiating competitive terms of sale for various countries. These arrangements may be more complex than those the seller is accustomed to negotiate in its own country, but they are familiar. It is the unusual type or degree of risk associated with exporting that makes this a rankling problem for financial managers.

Table 1: Exporters' Perceptions of Relative Severity of Credit, Currency and Political Risk

Perception of Export Sales	*Credit*	*Currency*	*Political*
Much more risky	13	40	39
Moderately more risky	37	36	30
Same degree of risk	21	7	10
Moderately less risky	12	4	4
Much less risky	6	2	1
Total Responses	89	89	84

Controlling Risk

Credit risk can be reduced by careful screening of buyers, tightening terms and conditions of sale, and use of export-credit insurance. As Table 1 indicates, credit risks are not perceived to be extremely high, although they are seen as riskier than those encountered in domestic sales.

When the responses are grouped on the basis of the respondents' most important regional export markets, it appears that:

- Among firms for which *Western Europe* is the primary export market, a high concentration considers that credit risks are moderately greater than in domestic business.
- Among firms for which *Latin America* is the primary export market, a high proportion considers that currency risks are much greater than in domestic business.
- Among firms for which *Latin America* is the primary market, there is also a marked tendency to consider that political risks are moderately great.
- Currency risks are not perceived to be as acute a problem in the *Far East* as in other parts of the world.

Currency risks can be reduced by hedging in the forward market; by use of exchange-rate option provisions in the original sales agreement (e.g., unit prices can be adjusted to compensate for adverse shifts in the rate of exchange); or by submitting the invoice in the exporter's currency. Political risks include a freeze on transfers of foreign exchange, as well as government changes that are unfriendly to the exporter. Such risks can be reduced by the purchase of appropriate insurance or, in the case of letter-of-credit transactions, by having a bank in the exporter's country confirm the letter of credit. Such confirmation assures payment to the exporter if the buyer's bank is unable to make dollar (or other hard-currency) payment. Table 2 summarizes the measures used to reduce risk and the rankings (1 = most important) of their importance.

Export Credit Insurance

Of 89 respondents who answered on this point, 26 use export-credit insurance; the majority do not. The companies using this service were asked to evaluate their experiences with three well-known U.S.-based insuring and guaranty institutions Export-Import Bank (EXIMBANK) Foreign Credit Insurance Association (FCIA), and the Overseas Private Investment Corporation (OPIC). Chart 1 summarizes these responses.

Financial Functions

Selling a company's products abroad entails some specialized financial activities. To a great extent, these also exist in domestic business, but they tend to be considerably more complicated in exporting. One result of this complexity has been the development of specialized services to assist exporters. These services are involved in obtaining information, transferring funds, establishing credit terms, and preparing documents.

Obtaining Information

The types of information U.S. exporters need is related to the risks they perceive. They need to know about the credit status of customers, possible delays in payments, foreign-exchange restrictions, and the political and economic stability

Table 2: Methods Used to Minimize Export Risks and Ranking as to Importance (89 Companies)

Method	*Rank* 1	2	3	4	5	*Total Mentions*
More rigorous terms of sale	49	24	4	–	–	77
More searching evaluation of customer's credit standing	19	31	12	2	1	65
Credit insurance	8	9	9	5	3	34
Political risk insurance	1	4	8	12	3	28
Use export trading company	2	2	4	3	6	17
Other	9	3	1	–	–	13

Chart 1.

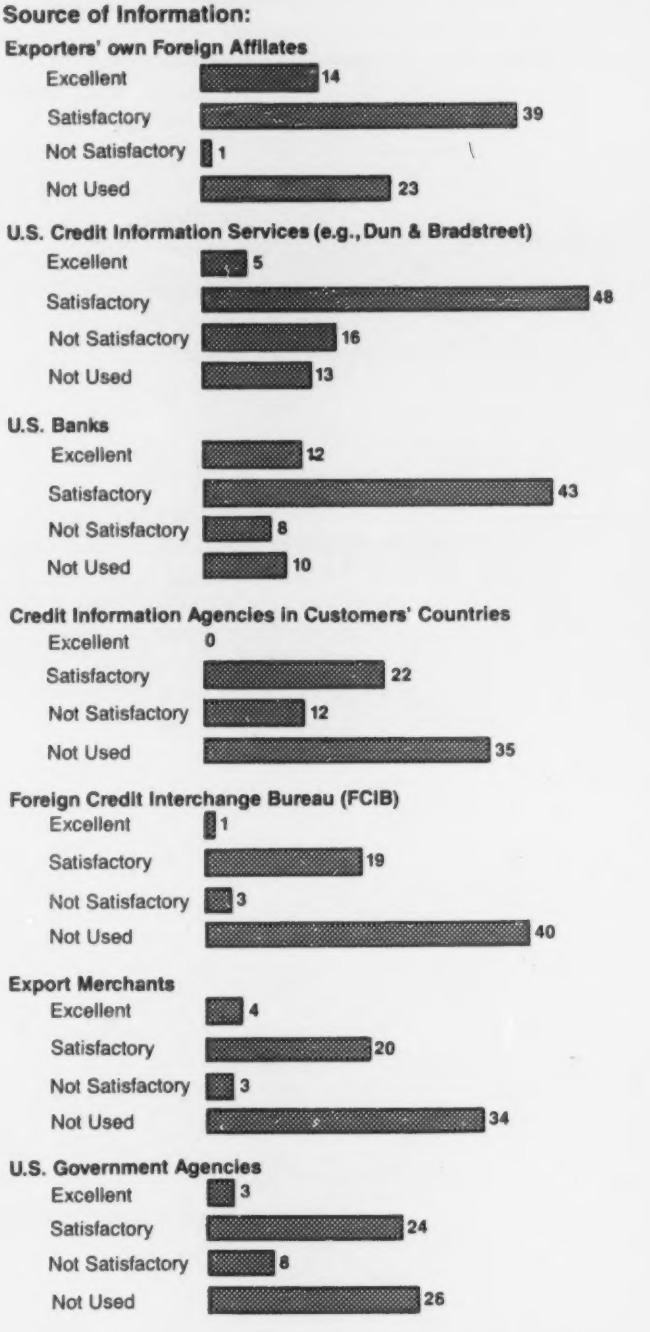
Exporters' Evaluation of Export Credit Insurance Suppliers

(Responses of 26 Companies)

* There were only 21 responses to this question.

Chart 2.

Exporters' Evaluation of Sources of Credit Information



Note: In addition to these sources, a few respondents also mentioned U.S. creditors, foreign distributors, competitors, and U.S. multinational companies. They all received either excellent or satisfactory evaluations.

of the buyer's country. These sources include the organizations shown in Chart 2 and specialized commercial credit reports, analyses of risk by country, and International Monetary Fund (IMF) data.

Because careful evaluation of their customers' credit standing is one of the principal means of minimizing the risks of selling in foreign markets, the respondents were asked to indicate the sources of credit information on which they rely and to evaluate them. U.S. credit-rating agencies and banks and the exporting firms' own foreign affiliate appear to be the most used and the most satisfactory.

Transferring Funds

International monetary transfers are not as predictable as those made domestically, especially with respect to the timing of payments. In the absence of a central settlement mechanism, international money transfers are carried out through a network of correspondent-bank relationships.

Many countries have enacted laws or imposed regulations to protect their currencies. This often involves no more than a requirement to report international transactions to the central bank. However, in some countries, every import or export must be authorized before a contract is signed, and every payment must be made under a specific license issued by the central bank.

The regulation of foreign-exchange markets is an important concern of U.S. firms that export. In countries where the currency is not convertible, a bank may be able to buy foreign currency from the central bank—provided the transaction is properly documented. Channeling all exchange transactions through such a single agency can, of course, cause delays.

Wide variations in the efficiency of banks from one country to another create another potential problem. In many less-developed countries, for example, there is a shortage of trained personnel. By contrast, the banks in Scandinavia are reported to be highly efficient although international transactions are strictly controlled in those countries. Because of the variety of problems related to banking and foreign-exchange and currency regulations, many exporters rely heavily on their domestic banks to effect money transfers. The following is a representative, but not exhaustive, list of money-transfer services of commercial banks:

(1) Buying and selling foreign currencies and making remittances;
(2) Collecting funds and drafts from foreign customers;
(3) Opening accounts in their own foreign branches (or other banks abroad) in which their customers can deposit the proceeds of export sales;
(4) Discounting drafts.

Payment Methods

The companies in this survey offer a variety of methods of payment to their foreign buyers. Eighty-six of the respondents furnished information about these terms. As might be expected, most offer several options (Table 3).

The most frequently mentioned combinations are: (1) letter of credit, open account, and cash; and (2) open account, letter of credit, and collection. As the table also indicates, open account and letter of credit are the most often used and are preferred.

Only four firms report that all their foreign sales are paid for by the same method: Three of these use letters of credit; the other uses open account. Eighty-five percent provide only short-term credits (maturity of one year or less); only seven percent provide credit for three years or more.

Twenty-eight of the seventy-three firms commenting on this point indicate that there are differences in the maximum maturity of credit they extend to customers in different parts of the world. Some base maturities on what the buyer's country requires. There is also a tendency to follow whatever practice prevails in the industry.

Table 3: Credit Terms and Payment Mechanisms (86 Exporters)

		Percent of Total Sales			
Method	*Mentions*	*0-25%*	*26-50%*	*51-75%*	*76-100%*
Letter of credit	80	33	22	12	13
Open account	75	23	24	14	14
Cash	43	36	4	1	2
Collection	29	22	6	1	0
Supplier credit	11	11	0	0	0
Other[1]	12	0	0	0	0
	250				

[1]Includes sight drafts and time drafts drawn on the buyer.

Another question in this area had to do with interest charged on the credit extended to foreign buyers. Exactly half of the 78 respondents offering information about this issue charge no interest; about a third charge an interest rate equivalent to (or less than) the seller's borrowing cost. Only 11 percent charge an interest rate greater than the seller's borrowing cost.

Documentation

Documents of various kinds are required in foreign-sales transactions. In many cases, they are essential for collecting the amount due and in transferring title to merchandise. Documents are also required for customs clearance and to satisfy port-of-entry and port-of-exit regulations.

Sales contracts frequently specify the documents necessary for a given transaction. Those most frequently required are: the draft, the commercial invoice, the bill of lading, and the insurance certificate.

Financial Services

As has already been indicated, a number of organizations and institutions have developed specialized services to assist exporting companies. The principal suppliers of these services are commercial banks, export merchants and managers, institutions sponsored by the United States government and by the insurance industry, and agencies of some state governments.

Commercial Banks

Close to 200 large- and medium-sized banks in the United States offer a selection of export-sales financial services. The responding companies were asked about their use of these services, and their experience with them. The results are summarized in Table 4. Five respondents supplied information about various other services provided by their commercial banks: Two named letters of credit (rated excellent); one mentioned credit reporting (rated not satisfactory); one referred to local currency loans (satisfactory); and one cited satisfactory experience with the scheduling of merchandise shipments.

Export Merchants and Other Organizations

The financial services provided to exporters by commercial banks are also offered by other organizations. For example, export merchants, export trade houses, and combination export managers (CEM's) also play important roles in financing exports. The respondents were asked to indicate the extent of their use of such services and to evaluate them. Table 5 presents a summary of the results.

In comparing these judgments with those of commercial banks, two things stand out: First, the responding companies use the bank services more than those offered by other organizations. Second, smaller proportions of respondents rate these services positively (excellent or satisfactory) when they are provided by nonbank institutions.

Table 4: Rating of Commercial Banks' Services (multiple responses)

Service	Rating			Do Not Use
	Excellent	Satisfactory	Not Satisfactory	
Processing and forwarding documents	15	55	5	6
Foreign-exchange services	15	32	1	29
Prompt payment to exporter	9	35	6	21
Loans to foreign customers	5	22	7	33
Other[1]	2	3	1	0

[1]Includes letter of credit, credit reporting, and freight forwarding.

Table 5: Rating of Services Provided By Export Merchants, Export Trade Houses, and Combination Export Managers

	Rating			Do Not Use
	Excellent	Satisfactory	Not Satisfactory	
Prompt payments to exporter	5	18	0	45
Provide credits and loans to foreign customers	0	10	3	49
Foreign exchange services	0	8	1	52
Processing and forwarding documents	3	21	0	41
Other	0	2	0	31

One recent innovation in financial services for exporters is the packaging of trade credit and credit insurance. This development appeared in 1982 with the start of the Trade Finance Corporation (TRAFCO), a packager of funds formed by the joint efforts of American International Group (AIG), a large export-credit insurer, and Salomon Brothers, a major investment-banking house. AIG insures the export credit, while Salomon Brothers underwrites the investment in the credit. Since its inception, the company is reported to have assumed commitments of about $1 billion.

Another firm that has entered this field is the New York-based Globex International Credit Corporation. Globex assists its clients in locating the most favorable terms for credit and insurance coverage on export transactions.

Federal Government and Industry-sponsored Services

Certain institutions sponsored by the U.S. government also provide services useful to exporters, as does the Foreign Credit Insurance Association, the creation of a group of private insurance companies. These institutions principally supply credit and provide insurance against the various risks already described. The most prominent of these organizations are the Export-Import Bank (EXIMBANK), the Foreign Credit Insurance Association (FCIA), the Private Export Funding Corporation (PEFCO), and the Commodity Credit Corporation (CCC).

The respondents were asked to comment on their familiarity with these institutions and their use of the services offered (Table 6). As the table shows, PEFCO and the CCC are least well known. The low rate of familiarity with CCC is probably explained by the specialized commodity orientation of that organization.

Although most of the respondents are aware of the other agencies, they make relatively little use of them. The nature and the manner of operations of these institutions may provide the explanation for this. For example, some exporters say that the availability of EXIMBANK funds is limited. In addi-

Table 6: Use of Services Offered by Specialized Government-Sponsored and Industry-Sponsored Institutions

	Number that Use Service	Number that Do Not	Number Unaware of Services
Export-Import Bank (EXIMBANK)	24	57	5
Foreign Credit Insurance Association (FCIA)	23	54	4
Overseas Private Investment Corporation (OPIC)	12	61	9
Private Export Funding Corporation (PEFCO)	7	60	13
Commodity Credit Corporation (CCC)	3	64	12

tion to providing direct loans from its own resources to finance U.S. exports, EXIMBANK provides guarantees to commercial banks that provide such services. It also offers export-credit insurance that is administered in cooperation with the Foreign Credit Insurance Association for short- and medium-term transactions, lines of credit to financial institutions, and discount loans to commercial banks.

More than 50 commercial property and liability insurers make up FCIA. It insures against commercial credit risks and political risks. FCIA operates under the sponsorship of the Export-Import Bank, which bears the ultimate losses resulting from war, revolution, import restrictions, currency blockage, cancellation of import licenses, expropriation, and similar political hazards. Several years ago, it was reported that the FCIA insurance program covers only a small portion of U.S. exports.[1] The companies in this sample did not offer reasons for not using FCIA's services, but the following are believed to be important factors:

(1) FCIA is not very flexible and does not respond quickly to exporters' needs. U.S. exporters often need an immediate answer concerning the availability of credit insurance.

[1]S.M. Huszagh and M.R. Greene, "FCIA: Help or Hindrance to Exports?" *Journal of Risk and Insurance* (College of Business, University of Georgia, Athens, Georgia 30602), June, 1982, pp. 258-259.

(2) Human-rights considerations remove some countries from consideration by FCIA.

(3) More competitive insurance rates may be required because FCIA's foreign competitors are aggressive operators, and because the governments of other industrialized nations are eager to promote exports by means of low-cost export-credit insurance, as well as by low interest rates on export credits.

As for OPIC, loan-investment-guaranty services are not available on a full global basis but are restricted to countries with which the United States has negotiated special investment treaties. Thus, the U.S. exporter would have to be selling to a buyer in a country with which the United States has such a treaty if it is to make use of OPIC's coverage against political risk.

Agencies of State Governments

State governments are a major new entry in the field of export credit. As of early 1985, 11 states had the legal basis to establish programs to assist exporters: (Colorado, Illinois, Indiana, Louisiana, Minnesota, Missouri, Ohio, South Carolina, Tennessee, Washington and Wisconsin.)

These programs operate principally by discounting banks' export credits and providing working capital.

Part II: Tax Incentives for Exporters

The entire problem of the present position of the United States with respect to exports is beyond the scope of this paper. However, the attempts to encourage U.S. companies by offering tax incentives to exporters is of particular concern to financial managers.

The Revenue Act of 1971 established a mechanism for the purpose of encouraging exports. It permitted the establishment of paper subsidiaries—Domestic International Sales Corporations, usually called DISC's. The principal tax feature of these organizations was the provision that a large share of the income tax that would normally be due on their earnings was allowed to be deferred until the earnings were distributed to the parent company. Many U.S. companies responded to this incentive; a large number of DISC's were established; and billions of dollars of income-tax liabilities have been deferred.

In view of the massive trade deficits of the United States and the noncompetitiveness of many of its products, it is hard to conclude whether or not DISC's have been successful in achieving their goal. Three of four executives providing information for this part of the study indicate that their DISC's have not lived up to the expectations originally held for them. The feeling among those who commented on this is that the poor competitive position of many of the nation's products requires other remedies—remedies that go beyond tax incentives for exporters. (See box for information on how these data were gathered.)

Successful or not, trading partners of the United States grew increasingly critical of the DISC legislation, complaining that the tax advantage enjoyed by a DISC was nothing more than a disguised export subsidy and, as such, violated the antisubsidy rules of GATT (the General Agreement on Tariffs and Trade). These criticisms were voiced despite the fact that many of these countries allegedly subsidize their own exports in various ways, such as by subsidizing export credits.

In any event, Congress abolished the old DISC in 1984 (as part of the Deficit Reduction Act). At the same time, this legislation forgave all of the income taxes—estimated at more than $13 billion—that had been deferred by U.S. firms under the 1971 legislation. The rationale for forgiveness of the deferred taxes was that exporters were entitled to be compensated for their efforts to build up exports, as Congress had intended. Some critics, in and out of Congress, however, objected to the forgiveness provision as an unjustified windfall for large exporters.

In the 1984 legislation, Congress also authorized a new format through which exporters could transact their overseas business and receive some tax advantage: the Foreign Sales Corporation, or FSC. Unlike DISC's these new subsidiaries are required to be based overseas. Instead of deferring the income tax on their earnings, up to 15 percent of the income tax owed by an FSC is immediately waived.

Sources of Information, Part II

This questionnaire had as its purposes to review the experiences of U.S. companies with DISC's; to examine how these companies were handling the accounting problems associated with phasing out those subsidiaries, specifically accounting for the forgiven taxes; and to get some idea of plans for establishing FSC's.

The questionnaire was distributed and the data gathered between the passage of the Deficit Reduction Act of 1984 and the expiration of the old DISC legislation at the end of 1984.

A total of 167 companies responded to the request for information. In most cases, this was provided by people with the titles of manager or director of taxation. Some were treasurers or assistant treasurers who had heavy responsibility for tax management.

Their principal lines of business are: 66% durable goods manufacturing; 17% nondurables manufacturing; 17% other. The largest group among the "others" consisted of export-management firms; the remainder were engineering and service companies, distributors, exporters and agricultural producers.

Almost half of the cooperating companies are of medium to small size, as measured by annual sales. However, larger companies were also represented, as the following tabulation shows.

Annual Sales	*Number of Companies*
More than $5 billion	8
$1 billion – $5 billion	23
$500 million – $1 billion	22
$100 million – $500 million	35
Less than $100 million	79
	167

It is not strictly accurate to say that the DISC has been abolished. U.S. exporters still have the option to establish a new, so-called interest-charged DISC. These new DISC's will be allowed to defer part of their annual income taxes, but they must pay interest (at Treasury-bill rates) to their parent companies on the amount of tax that is deferred. Early reaction to this new tax-incentive legislation (that went into effect on January 1, 1985) appears to be that it is less favorable to exporters than the former DISC system.

Experience with DISC's

Among the 167 responding companies, 155 operated at least one DISC at the time of the survey; 36 of these operated two or more. The principal reasons given for the existence of multiple DISC's are:

- Companies were acquired that already had a DISC;

- Separate DISC's were formed to cover different market segments;
- To provide for different fiscal years;
- To reduce the risk of having a DISC disqualified;
- To switch from a cash-basis DISC to an accrual basis.

The 155 firms also reported substantial use of this mechanism to effect exports, as the following tabulation shows:

Percent of Exports Through DISC's	*Number of Companies*
Over 75%	134
50% - 75%	10
25% - 50%	5
Under 25%	6
	155

The principal reasons cited for only slight use of DISC's are:

—The companies export engineering and construction services, the income from which is not subject to the tax-deferral DISC provisions.

—There was a need to retain foreign-source income to take advantage of foreign tax credits.

—DISC presents too many accounting problems.

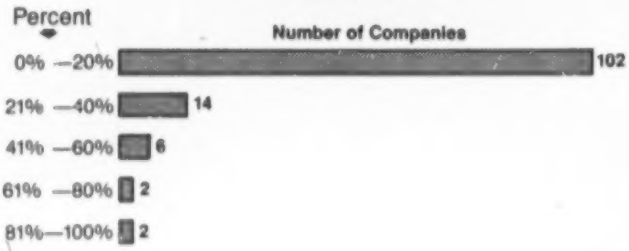
Although most of the respondents made extensive use of DISC's, the preponderant attitude is that these organizations were not absolutely essential to exporting success—even though they helped their sponsors to compete. One-fifth, however, do regard the DISC as absolutely essential to remain competitive. (See Table 7.)

Interest Income of DISC's

Because of their ability to defer payment of U.S. corporate income taxes, some DISC's have been able to accumulate funds which they invested and on which they earned interest. Based on this sample, however, it appears that the opportunity to generate such interest income has not been a major source of revenue in most cases. (See Chart 3.)

Chart 3.

Interest Income as a Percent of Total DISC Income



DISC Assets

Receivables from export customers are the most important assets held by DISC's. Table 8 summarizes the responses with respect to types of assets and their share in the total assets of the DISC's reported on.

Phasing Out DISC's

When companies with old DISC's phase them out, they face some major accounting decisions. Managements of some companies did not defer the income tax on DISC earnings because they did not want to postpone the recognition of the related earnings indefinitely. In such cases, DISC income was simply reflected as current income. It is important to distinguish between these firms and those that elected to report deferred taxes each year on the untaxed portion of DISC income. The current financial reporting of companies that *did not* accrue deferred taxes will be unaffected by the 1984 legislation.

Companies that *did* record deferred taxes, however, will now be required to recognize their accumulated deferred taxes as current income because these taxes were forgiven by the 1984 legislation. The Financial Accounting Standards Board (FASB) has issued a ruling that requires companies to report

Table 7: Importance of DISC to Exports

Contribution of DISC	*Number of Times Reported (multiple responses)*
Adds to ability to compete, but is not absolutely essential	89
Increases net return on export operations	82
Adds to liquidity of company	74
Provides financial flexibility	51
Absolutely essential to remain competitive	31
Other	3

Table 8: Assets Held by DISC's (multiple responses)

Type of Asset	*Number of Times Reported*
Accounts receivable from export customers	111
Notes of Private Export Funding Co.	47
Loans to affiliates	42
Notes of export customers	5
Other (including interest and commissions receivable, cash, inventory, minority interest in foreign company's stock)	27

the reversal of the deferred taxes as current income in the first financial statements issued after July 18, 1984.[2] This accounting treatment increases current reported income, but has no effect on a company's cash flow.

In this survey, 51 of the 155 companies that operated DISC's report that they have recorded deferred income taxes. Of these, 33 expect to report the reversal of these deferrals as current income in accordance with FASB Technical Bulletin 84-2. Ten of the other firms plan to transfer these deferred taxes to retained earnings, rather than to report them as current income. Eight of the respondents indicate that financial accounting treatment had not yet been determined, or that they intend to continue their present accounting until completion of IRS examinations.

The questionnaire attempted to find out what effects, if any, the tax relief might have on companies' capital expenditure or other investment plans. The responses of those providing this information are summarized in the tabulation:

Expected effects	*Number of Companies*
Reduce planned borrowing	34
Increase dividend distribution	17
Increase capital spending	13
Increase R&D spending	13
None	12
None, no effect on cash flow	2

Foreign Sales Corporation Plans

The respondents were asked if their companies had plans to organize the new entities: Foreign Sales Corporations. Of 143 companies answering, 116 intend to do so.

One factor that seems likely to discourage some firms from setting up an FSC is that, unlike the DISC, the FSC *must* conduct its business outside the United States. However, an offsetting advantage of the FSC format is that a group of exporters can get together to form a jointly owned FSC, thereby easing the cost and other pressures on the individual sponsors that are associated with doing business abroad.

U.S. companies that are already selling in overseas markets through foreign subsidiaries or agents are in a position to satisfy the FSC requirements with little or no additional operating costs. Respondents were requested to indicate the proportion of their foreign sales made through such agents. As the tabulation shows, more than a third of those answering this question generate half or more of their exports in this manner.

Percent of Sales Made Through Foreign Agencies	*Number of Companies*
0%	32
1-10%	11
11-20%	9
21-30%	11
31-40%	3
41-50%	9
51-60%	3
61-70%	4
71-80%	14
81-90%	12
91-100%	13
	121

Whether firms are in a position to extend their utilization of such services depends on the location of agents compared with the location of markets. If these do not match up, there could be substantial additional costs because of the foreign-location requirement for FSC's.

Changes in Export Activities

Companies that plan to organize an FSC were asked to identify what changes they anticipate in carrying out their export activities. Of the 110 providing information, 32 expect to increase their use of foreign agencies; 28 to increase their use of foreign affiliates; 20 to increase their use of both agencies and affiliates. The 30 companies that did not choose among these alternatives indicated that they expect that operating under FSC rules will bring increased costs (e.g., administrative expenses, operating an offshore office, expenses of establishing an offshore sales company, or additional tax department costs).

A small minority of the 110 respondents supplying information on this point indicate they are already operating overseas and will continue to do so; or they expect to operate as a small FSC; or they plan to set up a foreign office. In the latter case, their export procedures may be expected to change to comply with FSC regulations. A few firms are not yet certain how their export activities will be carried out, or whether their exports will be positively or adversely affected.

[2] "Accounting for the Effects of The Tax Reform Act of 1984 on Deferred Income Taxes Relating to Domestic International Sales Corporations," Technical Bulletin No. 84-2, September 18, 1984. Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905-0821.

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